

**APPEALS**  
**INDUSTRY SPECIALISATION PROGRAM**  
**COORDINATED ISSUE PAPER**

**INDUSTRY:** All Industries

**ISSUE:** Amortization of Employment  
Contracts

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## SETTLEMENT GUIDELINES

## EMPLOYMENT CONTRACTS

### STATEMENT OF ISSUE

Whether employment contracts entered into by a target company during acquisition negotiations are an asset of the target company where there is no substantial business purpose for the target company to enter into the employment contracts independent of the proposed sale of the company?

### EXAMINATION DIVISION'S, POSITION

Employment contracts entered into by a target company are not assets of the company unless:

- 1) the contract was entered into prior to the acquisition of the company,
- 2) the contract was not a precondition to the sale/purchase of the company, and
- 3) the contract was entered into for substantial business purposes independent of the proposed sale/purchase.

### BACKGROUND

As a condition of an acquisition the acquiring company requires, either as part of the written agreement or otherwise, the target company to enter into employment contracts with "key" employees (which may include stockholders of acquired closely held corporations). Customarily, these contracts seek to ensure that the "key" employees would continue in the target company's employ for a period of time after it was acquired and would not compete with the target company (or its successors) for the period of the contract.

*When* the stock or assets of a business are purchased, the purchase price may be allocated to the various assets to the extent of their fair market values pursuant to sections 338, 1060 or formerly section 334(b)(2). Briefly, depending on when the acquisition took place and on the method of asset allocation, either all the assets are valued separately, including goodwill and/or going concern value or, alternatively, all assets other than goodwill and/or going concern value are valued and the residual, if any, is allocated to goodwill and/or going concern value.

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*SETTLEMENT GUIDELINES: AMORTIZATION OF EMPLOYMENT CONTRACTS*

*DISCUSSION*

The Second Circuit in Barnes Group, Inc. v. United States, 872 F.2d 528, 532 (2d Cir. 1989) [89-1 USTC 19262] set forth the following with respect to the determination as to whether employment contracts are purchased assets with a basis that can be depreciated:

- 1) It must be determined when were "the key contracts entered into" and were they "conditioned upon the sale of the companies".
- 2) If "the contracts were entered into prior to, and were not conditioned upon, the acquisitions," then the purpose for which the contracts were entered into must be determined, "for the substance of a transaction is relevant to its tax treatment".
- 3) "While the buyer of a company is of course free to obtain employment contracts and covenants not to compete directly from the employees of the purchased company,..., we see no reason why the acquiring company should receive a tax benefit from having such contracts executed instead by the to-be-acquired company if the latter had no substantial business purpose for so doing independent of the proposed sale of the company, and the sole purpose of the act was to increase the acquiring company's tax benefits in connection with the purchase and impending liquidation of the company."

Upon remand, the District Court found that the contracts were executed on the same date as the execution of the stock purchase agreement. It also found that the contracts had no substance because the period of employment would start "on the day of acquisition by Barnes Group, Inc."; therefore they had no force and effect until consummation of the sale. It was also found that the contracts served no purpose of the target companies independent of the sale of the companies. Barnes Group, Inc. v. United States, 724 F. Supp. 37, 40-44, (D. Conn. 1989), a f 'd 902 F.2d 1114 (2d Cir. 1990).

In Barnes the contracts were expressly conditioned upon the sale of the target company; they were to have "no force and effect" if the sale was not consummated. Additionally, the contracts were obtained at the insistence of Barnes. As stated by the Court of Appeals, even if the contracts were not conditioned upon the sale, the purpose for which the contracts were entered into must be examined. The contract must have had a business purpose other than

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the proposed acquisition for it to be an asset of the target company.

The District Court in coming to its conclusion that the existence of the contracts did not serve any purpose of the target companies considered the following:

1. The target companies over their history had no need, purpose, benefit or advantage for these contracts until requested by Barnes.
2. A purpose beneficial to the target company is not served when the contracts are signed on the eve of the dissolution of the company, which was then planned and contemplated.
3. The target companies acquired no rights from the contracts until the acquisition was complete.
4. The target companies gave no consideration or obligation until the acquisition was complete; thus the employee had no obligation until the transaction was completed.
5. There could be found in the contracts no purpose of the target, for the contracts were of no force or effect until the acquisition.
6. A contract that terminates if the acquisition is not completed shows a lack of any advantage, right, benefit or entitlement which serves a purpose of the target.

The Court found that since the contracts were obtained at the insistence of Barnes it was for its purposes and not those of the targets'.

The District Court, on remand, addressed KFOX, Inc. v. United States, 510 F.2d 1365 (Ct. Cl. 1975) where employment contracts of key employees had non-competition clauses, a case relied upon by Barnes. The court found the case inapposite. It said that the facts were not the same since it was not shown, as with Barnes, that the contracts were contingent upon the acquisition.

In KFOX as a condition to final agreement the prospective buyer had two stipulations, one, relevant to this issue, being that the station manager and four disc jockeys sign personal service contracts with non-compete clauses. When the stipulations were met the sales agreement was signed. The Government argued that there was a direct and definite relationship between *the* contracts and

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the institutional goodwill of XFOX, therefore they were not susceptible to separate valuation. Accordingly, it did not furnish any rebuttal to taxpayer's values. The Court found that the taxpayer had presented clear evidence showing that the contracts had significant and measurable value independent of goodwill. It also accepted the values used by the taxpayer stating that sufficient evidence had been submitted to substantiate said value; the fact that the government submitted no evidence was also a factor. Additionally, the court did not address the issue whether the contracts were assets of the target because the government never raised it.

In KFOX the taxpayer valued one of the contracts, the station manager's, based upon cost savings, it was shown that to replace him would cost substantially more than he was being paid. The other contracts, the disc jockeys', were based upon advertising revenue generated by them.