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# Viewpoint on Value



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## Assessing the value of a noncompete

Noncompete agreements are used to smooth management transactions after a merger or acquisition closes. After all, business buyers don't want valuable assets — such as trade secrets, key employees and business relationships — to walk out the door with the seller.

But how much are noncompetes *really* worth? Purchase price allocations have important tax and accounting implications when one is buying and selling business interests. In an M&A context, noncompetes are contractual agreements that restrict sellers from competing in the same industry for a given time period within a specific geographic area. For tax purposes, the value allocated to noncompetes must be reasonable and agreed to by both sides.

Noncompete appraisal is often a sticking point for buyers and sellers in business combinations. Buyers typically amortize noncompetes over 15 years, regardless of terms or payment conditions. The higher the value assigned to noncompetes, the more amortization the buyer can deduct in future periods.

Sellers normally recognize ordinary income for amounts allocated to noncompetes. Ordinary income tax rates are generally higher than capital gains tax rates, so sellers typically prefer lower values assigned to noncompetes.

A valuator typically begins by using the 11-factor test set forth in *Thompson v. Commissioner* to assess economic reality, looking at such factors as the grantor's (seller's) business expertise, intent to compete and economic resources as well as the potential damage to the grantee (buyer).

Next the valuator appraises the business with, and without, the noncompete agreement. Noncompete value equals the difference between these two values, net of the expected tax savings from amortizing the agreement and adjusted for the probability that the seller would actually compete with the buyer.

As a final step, an appraiser typically estimates the percentage of noncompete value to total selling price. Then, as a sanity check, he or she compares the subject company's ratio to the ratio observed in comparable transactions.

Do you have a  
**Question?**  
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