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Noncompetes as Tax Evasion

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NONCOMPETES AS TAX EVASION

REBECCA N. MORROW*

ABSTRACT

Al Capone famously boasted of his criminal empire: “Some call it bootlegging. Some call it racketeering. I call it a business.” Treasury Agent Frank Wilson and Prosecutor George Johnson put Capone behind bars not by disputing his characterization and pursuing murder or assault or RICO charges, but by accepting it and enforcing its tax implications. Irrespective of their legality, Capone’s businesses were profitable, and Capone had not reported their profits for tax purposes. A simple application of bedrock tax law achieved what other legal routes failed to achieve and sent Capone to Alcatraz. The trick was to see the tax argument.

Policymakers should use a similar approach to curtail the excessive, exploitative, and anticompetitive use of employment noncompete agreements. Currently, nearly one in five (or thirty million) American workers is bound by an employment noncompete. Employers claim that they adequately compensate employees for noncompete restrictions with higher wages, bigger raises, and/or more generous bonuses. Policymakers scoff at this claim and use contract law to attack them. Unfortunately, employment noncompetes are like Al Capone in that they have flourished despite the law’s efforts to restrain them. Recently, the largest study of noncompetes in U.S. history paradoxically found that their prevalence is unaffected by their enforceability. In states like California that refuse to enforce employment noncompetes, they are as common as in states that uphold them. Contract law has proved ill-equipped to respond to the pervasive, expanding, and damaging use of noncompetes.

This Article is the first to shift the focus and to argue that employment noncompetes, as employers currently use them, constitute tax evasion and should be attacked as such. If employers pay employees for noncompetes through compensation, then by employers’ own account, this compensation is not purely an expense associated with immediate benefits; rather, it is an

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expenditure associated with future benefits—benefits that the employer will enjoy years after payment. Thus, the IRS should stop allowing employers to fully immediately deduct the compensation they pay to employees subject to noncompetes and instead should require that an adequate portion of total compensation be allocated to the noncompete and amortized over the restricted period, beginning when employment ends.

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INTRODUCTION

An employment noncompete is a contract between an employer and employee by which the employee agrees not to work for a competitor or open a competitive business for a specified period following the termination of her current employment relationship.¹ It restricts competition “for a specified period of time in a designated geographical area.”² Often, an employee becomes subject to a noncompete as a condition of obtaining employment, continuing employment, receiving a promotion, or receiving a bonus.³

Employment noncompetes are unlike and should be distinguished from business-sale noncompetes,⁴ a type of contract that is not the subject of this Article.⁵ Unlike a business-sale noncompete, which begins to run

1. J.J. Prescott, Norman D. Bishara & Evan Starr, *Understanding Noncompetition Agreements: The 2014 Noncompete Survey Project*, 2016 MICH. ST. L. REV. 369, 371 n.1 (2016); *see also* Norman D. Bishara & David Orozco, *Using the Resource-Based Theory to Determine Covenant Not to Compete Legitimacy*, 87 IND. L.J. 979, 987 (2012).

2. Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 626 (1960).

3. *See* Evan Starr, Norman Bishara & J.J. Prescott, *Noncompetes in the U.S. Labor Force* 44 (Univ. of Mich. Law & Econ., Research Paper No. 18-013, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2625714 (showing in Table 2 that 60.8% of survey respondents subject to a noncompete first learned about the noncompete before accepting a job offer, 29.26% learned after accepting a job offer, and 2.22% learned before accepting a promotion or raise).

4. *See, e.g.*, Prescott, Bishara & Starr, *supra* note 1, at 371 n.1 (contrasting employment noncompetes and business sale noncompetes).

5. Noncompete agreements that are incident to the sale of a business are less problematic than employment noncompetes for many reasons. For tax purposes, they are less problematic because, unlike employment noncompetes, they are not immediately deducted but instead amortized according to the rules of 26 U.S.C. § 197 (2016). For public policy purposes, they are less problematic because they protect interests that courts view as more legitimate and involve parties of roughly equal bargaining power. *See, e.g.*, Blake, *supra* note 2, at 647 (“Unlike a restraint accompanying a sale of good will, an employee restraint is not necessary for the employer to get the full value of the thing being acquired—in this case, the employee’s current services. The promise not to act in certain ways after terminating employment is something additional . . .”); *id.* at 647–48 (“[T]he parties to an employee covenant are often of unequal bargaining power and, thus, [] there is less likelihood that the covenant was actually bargained for. They may find that the employee has improvidently given up his only valuable economic asset, specialized proficiency arising from experience or training.”); Arthur Murray Dance Studios of Cleveland, Inc. v. Witter, 105 N.E.2d 685, 703–04 (Ohio Ct. Com. Pl. 1952) (distinguishing between noncompetes incident to the sale of a business and, more suspect, employment noncompetes); Holland Ins. Grp., LLC v. Senior Life Ins. Co., 766 S.E.2d 187, 191 (Ga. Ct. App. 2014) (quoting Murphree v. Yancey Bros. Co., 716 S.E.2d 824 (2011)) (“[R]estrictive covenants that are ancillary to employment

immediately, an employment noncompete does not begin to run immediately.⁶ Rather, the restricted period of an employment noncompete begins only upon termination of the employment relationship.⁷ While the “exact terms of [employment] covenants not to compete will vary widely . . . [the] unifying element is that once the employment is ended (by either party and under any circumstances in some cases) the employee is, in theory, not allowed to compete against the former employer”⁸ for the restricted period, often twelve months,⁹ or eighteen months,¹⁰ or twenty-four months,¹¹ following termination. Thus, while employment noncompetes typically are signed pre- or mid-employment, they limit “the *post-employment* mobility of an employee.”¹²

The need to curtail employment noncompetes is great. Employment noncompetes have been used, and have attracted judicial and political skepticism, for over half a millennium.¹³ Recently, however, their use has become more common,¹⁴ causing “a near explosion in the attention being paid to [employment] noncompetes and their effects” by media outlets, policymakers, economists, and legal scholars.¹⁵ While policymakers, economists, and legal scholars generally acknowledge that employment noncompetes can encourage training and innovation by protecting

contracts receive strict scrutiny . . . because it is generally true in an employer/employee relationship that the employee goes into a transaction such as this at a great bargaining disadvantage . . .”).

6. Of course, there may be other policies like anti-moonlighting policies that prevent competition during the period of active employment.

7. Norman D. Bishara & Evan Starr, *The Incomplete Noncompete Picture*, 20 LEWIS & CLARK L. REV. 497, 504 (2016) (“Covenants not to compete are a *post-employment* restrictive covenant between an employer and an employee that prohibits the employee from going to work for a competitor or otherwise competing with the former employer.”) (emphasis added).

8. Bishara & Orozco, *supra* note 1, at 987.

9. See, e.g., *infra* note 46 and accompanying text (noting that Jimmy John’s prior employment noncompete agreement restrained employees for more than twelve months).

10. See, e.g., *infra* note 37 (noting that Amazon’s prior employment noncompete agreement restrained employees for eighteen months).

11. See, e.g., Sophie Quinton, *These Days, Even Janitors Are Being Required to Sign Non-Compete Clauses*, USA TODAY (May 27, 2017, 8:28 AM), <https://www.usatoday.com/story/money/2017/05/27/noncompete-clauses-jobs-workplace/348384001/> [<https://perma.cc/44HV-PN9S>] (telling the story of Krishna Regmi, a Bhutanese refugee resettled in Pennsylvania, who worked for nine months as a personal care aide for a home health care agency and then was sued by that agency when it sought to enforce a noncompete prohibiting him from “working as a personal care aide at another home health agency for two years.”).

12. Prescott, Bishara & Starr, *supra* note 1, at 371 n.1 (emphasis added); see also Bishara & Orozco, *supra* note 1, at 986–87.

13. Blake, *supra* note 2, at 626 (explaining that covenants not to compete “comprise one of the traditional common-law ‘restraints of trade’ and present problems which have kept them before the courts for more than five hundred years”); *id.* at 631 (describing *Dyer’s Case*, decided in 1414, in which the English court declared a restraint on competition “void with no consideration of the reasonableness of its scope.”).

14. Prescott, Bishara & Starr, *supra* note 1, at 380 & n.41.

15. *Id.* at 372; see also Bishara & Orozco, *supra* note 1, at 983 (“Noncompetes and their possible impact have received attention from a broad range of researchers.”).

employers from the risk that their employees will “misappropriate trade secrets or other legally-protected intellectual properties,” they overwhelmingly conclude that the harms of noncompetes far outweigh their potential benefits, particularly as noncompetes are currently overused.¹⁶ Employment noncompetes are deliberately anti-competitive contracts that undermine important public policy goals like economic growth and knowledge-sharing while locking employees out of employment opportunities and making them susceptible to exploitation by the employers to whom they are bound.¹⁷ At a minimum, studies indicate that employment noncompete agreements are significantly overused.¹⁸

The political will to curtail employment noncompetes is also great. Courts, federal policymakers, and state legislatures have attempted to limit the harms caused by employment noncompetes by advocating and, in various jurisdictions, implementing resistance grounded in contract law. Most states will only enforce a noncompete if it is judicially determined to be reasonable in duration, scope, and geographic reach.¹⁹ Further, most states have sought to protect employees with a variety of additional procedural and substantive safeguards.²⁰ California and North Dakota have gone so far as to prohibit judicial enforcement of employment noncompetes.

Despite the need and political will to curtail employment noncompetes, however, courts overwhelmingly find that they are supported by adequate consideration. When employers are forced to defend employment noncompetes as valid, enforceable contracts that comply with judicially-imposed reasonableness standards, they consistently and successfully argue that they adequately compensate their employees for being subject to noncompete restrictions through enhanced employment benefits. Employers have successfully argued to courts across the nation that an employer’s decision to hire an employee, retain an at-will employee,

16. See, e.g., Gilson, *infra* note 60; COUNCIL OF ECON. ADVISERS, *infra* notes 69–72; THE WHITE HOUSE, *infra* note 63; OFFICE OF ECON. POLICY, U.S. DEP’T OF TREASURY, *infra* note 27; Starr, Prescott & Bishara, *infra* note 81; LOBEL, *infra* note 26; Amir & Lobel, *infra* note 89.

17. See *infra* Part I.B (detailing many harms of noncompetes).

18. See *infra* Part I.A (detailing how frequently noncompetes bind employees who do not have access to legally-protectable information).

19. See *infra* note 132 and accompanying text.

20. See *infra* Part I.C (detailing a variety of state law approaches to curtailing employment noncompetes).

promote an employee, pay a salary to an employee, award a raise to an employee, pay a bonus to an employee, grant stock options to an employee, or otherwise to provide or increase compensation to an employee constitutes adequate consideration provided by the employer to the employee in exchange for the noncompete. These findings prevent contract law from being a more effective approach to curtailing employment noncompetes. However, as this Article aims to show, they also suggest a new—and potentially far more effective—approach.

While well-intentioned and varied, efforts to curtail employment noncompetes through contract law have failed. Employment noncompetes have flourished despite contract-law-based efforts to restrain them. Recently, the largest study of employment noncompetes in American history found that, paradoxically, the prevalence of employment noncompetes is unaffected by their enforceability. In states like California that refuse to enforce noncompetes, they are as common as in states that uphold them. Contract law has proved ill-equipped to respond to the pervasive, expanding, and damaging use of noncompetes.

This Article is the first to propose a new and potentially far more effective approach—a tax-law-based approach—to curtailing employment noncompetes. When viewed through the lens of tax law, an employment noncompete is not simply a contract to be challenged by the employee and upheld, modified, or set aside by the court. It is also an intangible asset of the employer, increasing that employer's *future* market share and *future* business opportunities.²¹ According to employers' own accounts, and the vast case law upholding their accounts, employers pay their employees for becoming subject to noncompetes through compensation. In other words, employers buy employment noncompetes with a portion of the compensation that they pay to employees subject to noncompetes.

One innovation of this Article is to expose that, when an employer pays for a noncompete, it is a long-term expenditure. An employment noncompete is an intangible asset that primarily benefits employers in future tax years, beginning when the employment relationship ends. Tax law dictates that when a long-term expenditure is paid for with employment compensation, payments for long-term expenditures are not immediately deductible. Rather, payments for long-term expenditures must be

21. Blake, *supra* note 2, at 627 (“From the point of view of the employer, postemployment restraints are regarded as perhaps the only effective method of preventing unscrupulous competitors or employees from appropriating valuable trade information and customer relationships for their own benefit. Without the protection afforded by such covenants, it is argued, businessmen could not afford to stimulate research and improvement of business methods to a desirably high level, nor could they achieve the degree of freedom of communication within a company that is necessary for efficient operation.”).

capitalized.²² If a long-term expenditure has a determinable useful life, then the payment to acquire it is amortized ratably over its useful life.²³ The principle that only current expenses (payments that cause benefits overwhelmingly within the tax year) are immediately deductible, while long-term expenditures (payments that cause significant benefits beyond the tax year) are not immediately deductible and instead must be capitalized and, if appropriate, amortized is bedrock tax law.²⁴

A further innovation of this Article is to expose that employers appear to be engaged in widespread violations of this bedrock principle of tax law. Case law indicates that, even as employers claim to compensate their employees for becoming subject to noncompete agreements, they do not allocate *any* portion of compensation to the noncompete agreement. Instead, they immediately deduct the full amount of compensation—including wages, raises, bonuses—that they pay to their employees as though it is exclusively in exchange for their employees' current labors and not even partially in exchange for their employees' agreements to be subject to a noncompete. In other words, they claim in contract law what they disclaim in tax law.

It is stunning, given that many policymakers at federal and state levels have long searched for ways to curtail the use of employment noncompete agreements, that the IRS appears not to have challenged employers' widespread violations of tax law. The IRS has not demanded that any portion of compensation be allocated to employment noncompetes. Nor has the IRS disallowed any portions of the immediate deductions that employers have taken for the compensation they pay to their employees who are

22. To be capitalized means to create or add to basis. So, the amount paid to acquire a long-term expenditure is not immediately deducted; it creates a cost basis in the expenditure that is recovered gradually through amortization or, in the case of intangibles that are ineligible for amortization, is recovered upon disposition of the asset.

23. Regulation 1.167(a)-3 provides for ratable amortization over the useful life of certain intangibles. Treas. Reg. § 1.167(a)-3 (as amended in 2004). A different rule applies if the intangible is acquired as part of the acquisition of a trade or business, and that rule requires ratable amortization of all intangibles acquired in connection with the trade or business over the fifteen-year period following acquisition of the trade or business. *See* 26 U.S.C. § 197 (2016).

24. *See, e.g.,* Encyclopedia Britannica, Inc. v. Comm'r, 685 F.2d 212, 214 (7th Cir. 1982) ("The object of sections 162 and 263 of the Code, read together, is to match up expenditures with the income they generate. Where the income is generated over a period of years[,] the expenditures should be classified as capital . . .").

subject to noncompetes. The IRS—like employers—behaves as though compensation is exclusively in exchange for employees' current labors and is not even partially in exchange for employees' agreements to be subject to noncompetes.

This Article proposes a change. The IRS should stop allowing employers to fully, immediately deduct the compensation that they pay to employees subject to noncompetes. Stopping this practice would end a significant and unexamined tax subsidy in favor of employers using and expanding employment noncompetes.²⁵ Instead, when an employer subjects an employee to a noncompete, the IRS should require the employer to establish the value of that noncompete. It is an intangible asset with future value that the employer will receive gradually over the restricted period, beginning after the employment relationship ends. Then, the IRS should require the employer to allocate the employee's total compensation between a portion that pays for the noncompete and a remaining portion that compensates for current labor. The portion allocated to the noncompete should not be immediately deductible. Instead, it should be capitalized and amortized ratably over the restricted period. The IRS should permit immediate deduction only for the portion of compensation that is for current labor.

The Article proceeds in five Parts. Part I will detail the prevalence and harms of employment noncompetes. Part II identifies features of contract-law-based approaches to curtailing noncompetes that have prevented these approaches from being more successful. If future approaches are to be more successful, they should not share these features. Part III exposes the IRS's current treatment of employment noncompetes and argues that it is wrong. Although fundamental, normative rules of income tax require that costs associated with future benefits be capitalized and recovered gradually over the period benefitted, the IRS has ignored these rules by allowing employers to fully, immediately deduct the compensation that they pay to their employees in exchange for noncompetes. The IRS's current treatment of employment noncompetes unfortunately incentivizes employers to use them more frequently and more broadly than they otherwise would. Part IV proposes that employers should no longer be allowed to immediately deduct the compensation that they pay to employees subject to noncompetes. It details how employers should be required to capitalize the portion of compensation equal to the value of the noncompete. Part V is optimistic because this tax-law-based approach to curtailing noncompetes avoids the

25. When employers immediately deduct the full cost of an investment that has long-term value, that treatment is equivalent under certain conditions to exempting the investment from tax. *See infra* notes 271–277 and accompanying text; *see also* *Ford Motor Co. v. Comm'r*, 71 F.3d 209 (6th Cir. 1995) (discussing the importance of the timing of a deduction).

many features that caused contract-law-based approaches to fail. As a result, it holds unique promise.

I. PREVALENCE AND HARMS OF EMPLOYMENT NONCOMPETES

A. Prevalence

Employment noncompetes restrain an increasing number of American workers.²⁶ Currently, nearly one in five (or thirty million²⁷) American workers is covered by an employment noncompete agreement. The largest study of noncompete use in the United States was conducted in 2014²⁸ by researchers J.J. Prescott, Norman D. Bishara, and Evan Starr. Their survey was “completed by more than 11,500 labor force participants from a range of industries and with varied demographics, experiences, earnings, and expectations”²⁹ and found that “38.1% of employees had signed a noncompete at some point in their lives”³⁰ and currently, “about 18% of labor force participants are bound by noncompetition agreements.”³¹ As the Treasury Department’s Office of Economic Policy reported, this means that nearly thirty million American workers are currently covered by employment noncompete agreements.³² Accordingly, understanding the consequences of employment noncompete agreements “for workers and the broader economy is therefore of great importance, especially in light of its central role in determining workers’ prospects for wage growth and job mobility.”³³

26. See, e.g., ORLY LOBEL, *TALENT WANTS TO BE FREE: WHY WE SHOULD LEARN TO LOVE LEAKS, RAIDS, AND FREE RIDING* 793–833 (2013) (describing the expansion of employment noncompetes and other employer tools for restricting employee job mobility).

27. See OFFICE OF ECON. POLICY, U.S. DEP’T OF TREASURY, *NON-COMPETE CONTRACTS: ECONOMIC EFFECTS AND POLICY IMPLICATIONS* 6 (2016), <https://www.treasury.gov/resource-center/economic-policy/Documents/UST%20Non-competes%20Report.pdf> [<https://perma.cc/84RF-6LWZ>].

28. Prescott, Bishara & Starr, *supra* note 1, at 397.

29. *Id.* at 395.

30. Starr, Bishara & Prescott, *supra* note 3, at 2; see also OFFICE OF ECON. POLICY, U.S. DEP’T OF TREASURY, *supra* note 27, at 6 (estimating that about thirty-seven percent of workers have been subject to a noncompete at least once during their careers).

31. Prescott, Bishara & Starr, *supra* note 1, at 461.

32. OFFICE OF ECON. POLICY, U.S. DEP’T OF TREASURY, *supra* note 27, at 6.

33. *Id.* at 25.

While employment noncompetes were initially designed to prevent highly-compensated executives from appropriating valuable and protected company secrets, they increasingly restrain post-employment opportunities for lower-wage workers who are unlikely to have access to these secrets.³⁴ According to the 2016 Department of Treasury Report, less than half of workers bound by noncompete agreements report that their jobs give them access to trade secret information.³⁵ Approximately 15% of workers without four-year college degrees and approximately 14% of workers earning \$40,000 or less annually are covered by noncompete agreements even though these workers are less than half as likely to have access to trade secret information as their coworkers with degrees or higher annual earnings.³⁶

Well-known companies have used employment noncompetes aggressively with their rank-and-file employees and have encountered media and public criticism as a result. For example, Amazon subjected hourly and even seasonal workers to employment noncompetes, providing that “for 18 months after the Separation Date, Employee will not, directly or indirectly, whether on Employee’s own behalf or on behalf of any other entity (for example, as an employee, agent, partner, or consultant), engage in or support the development, manufacture, marketing, or sale of any product or service that competes or is intended to compete with any product or service sold, offered, or otherwise provided by Amazon (or intended to be sold, offered, or otherwise provided by Amazon in the future) that Employee worked on or supported, or about which Employee obtained or received Confidential Information.”³⁷ Amazon’s employment noncompete did not contain any geographic limitation and, in fact, included a recitation whereby the employee acknowledged that “the geographic areas for many of Amazon’s products and services — and, by extension, the geographic areas applicable to [the noncompete] restrictions . . . are extremely broad and in many cases worldwide.”³⁸ Amazon’s use of employment noncompetes was exposed and criticized by the online publication, *The Verge*. As *The Verge*’s reporting noted, since Amazon sells an

34. See, e.g., *id.* at 7 (“The conventional picture of a workplace characterized by non-compete agreements is one that features trade secrets, including sophisticated technical information and business practices that firms have a strong interest in protecting.”).

35. *Id.* at 4.

36. *Id.*

37. Spencer Woodman, *Exclusive: Amazon Makes Even Temporary Warehouse Workers Sign 18-Month Non-Competes*, *THE VERGE* (Mar. 26, 2015, 11:44 AM), <https://www.theverge.com/2015/3/26/8280309/amazon-warehouse-jobs-exclusive-noncompete-contracts> [<https://perma.cc/T5WN-7N JW>].

38. *Id.*; Jana Kasperkevic, *Amazon to Remove Non-Compete Clause from Contracts for Hourly Workers*, *THE GUARDIAN* (Mar 27, 2015, 17:56 PM), <https://www.theguardian.com/technology/2015/mar/27/amazon-remove-noncompete-clause-contracts-hourly-workers> [<https://perma.cc/FG35-CDH7>].

“extraordinary breadth” of products, this noncompete provision required “temp[orary] workers to foreswear a sizable portion of the global economy in exchange for a several-months-long hourly warehouse gig.”³⁹ The necessity of such a broad restriction is hard to justify, especially for workers like the couple featured in the article, Regina and Ray Lee, who perform seasonal warehouse work for Amazon and “box stuff every day and send it off.” Following this scrutiny, Amazon admitted that it had subjected seasonal and hourly workers to the noncompete provision but had not enforced it against them.⁴⁰ Amazon then agreed to remove the clause from employment contracts with seasonal and hourly employees.⁴¹

Jimmy John’s sandwich chain faced not only media scrutiny but a state-initiated lawsuit for its gratuitous use of employment noncompetes. On June 8, 2016, Illinois Attorney General Lisa Madigan filed a Complaint against Jimmy John’s calling its use of employment noncompete agreements “unreasonable, unconscionable, and unenforceable under Illinois law”⁴² Specifically, the Complaint alleges that for years,⁴³ Jimmy John’s required even “at-will, low-wage employees,”⁴⁴ whose “primary function concerns the receipt of orders, the preparation of food, and the delivery of food,”⁴⁵ to “sign non-competition agreements that limit their employment options *for years after leaving employment at a [Jimmy John’s] sandwich shop.*”⁴⁶ Because the same noncompete “agreement was required for all employees . . . irrespective of title or job function” and newly hired employees “were required to sign [it] as a condition of employment,”⁴⁷ it reached many

39. Woodman, *supra* note 37.

40. Kasperkevic, *supra* note 38 (quoting an Amazon spokeswoman saying that the noncompete “clause hasn’t been applied to hourly associates”).

41. *Id.* (quoting an Amazon spokeswoman saying that Amazon would remove the noncompete clause for hourly associates).

42. Complaint for Declaratory Judgment, Injunctive Relief, & Other Equitable Relief at ¶ 52, Illinois *ex rel.* Madigan v. Jimmy John’s Enters., No. 2016CH07746 (Ill. Cir. Ct. June 8, 2016), 2016 WL 3211206; Daniel Wiessner, *Illinois Attorney General Sues Jimmy John’s over Non-Compete Agreements*, REUTERS (June 8, 2016, 7:05 PM), <https://www.reuters.com/article/us-jimmyjohns-law-suit-idUSKCN0YU2RS> [<https://perma.cc/4DEG-DHP8>].

43. Complaint for Declaratory Judgment, Injunctive Relief, & Other Equitable Relief, *supra* note 42, at ¶ 50.

44. *Id.* at ¶ 1.

45. *Id.* at ¶ 13.

46. *Id.* at ¶ 1 (emphasis added).

47. *Id.* at ¶ 18.

employees with no or only “minimal access to confidential or trade secret information.”⁴⁸

Like Amazon, Jimmy John’s stated that it did not intend to enforce the noncompete agreements against its former sandwich makers or delivery employees.⁴⁹ However, secretly planning not to enforce a written contract provision does not solve the problem. As the Complaint alleges, noncompete agreements “can significantly disrupt the labor market”⁵⁰ even if they are not enforced because, “particularly with respect to the low-wage workforce[,] [they] . . . have a chilling effect on the efforts of employees to seek continued employment in a field in which they have gained familiarity.”⁵¹ Further, “[t]he use of non-competition agreements for at-will, low-wage workers . . . hinders upward mobility of workers looking for higher wages or advancement . . . and suppresses wages for employees who have limited negotiating power with both current and potential new employers.”⁵²

Restraining the employment opportunities of low-wage workers is troubling from a distributional perspective. It is also troubling from a macro-economic perspective. As the Complaint alleges, noncompete agreements “have a chilling effect on the ability of Illinois businesses to freely hire workers, by potentially subjecting these businesses to litigation, and by limiting the pool of available workers.”⁵³ In December 2016, the case was settled by a consent decree requiring Jimmy John’s to rescind existing noncompetes, remove all noncompetes from “new hire” paperwork, and “[n]otify all current and former employees that their non-competition agreements are unenforceable.”⁵⁴

B. Harms

Media outlets and attorneys general are right to be concerned. Employment noncompetes have extensive negative growth effects, negative distributional effects, and negative ethical effects. These harms far outweigh the benefits that employment noncompetes provide by encouraging employers to train their employees, trust their employees, and fully involve their employees in innovation.⁵⁵

48. *Id.* at ¶ 15.

49. *Id.* at ¶ 27.

50. *Id.* at ¶ 69.

51. *Id.*

52. *Id.* at ¶ 70.

53. *Id.* at ¶ 69.

54. Press Release, Ill. Attorney General, Madigan Announces Settlement with Jimmy John’s for Imposing Unlawful Non-Compete Agreements (Dec. 7, 2016), http://www.illinoisattorneygeneral.gov/pressroom/2016_12/20161207.html [<https://perma.cc/4CVE-A6SE>].

55. *See supra* note 16.

1. Negative Growth Effects

Employment noncompete agreements undermine competition. They deprive the economy of employee productivity and make workers less productive.

For several centuries, courts and policymakers have understood the anticompetitive nature of noncompete agreements and have looked for ways to mitigate their anticompetitive harms. As Harlan Blake noted in his seminal article, *Employee Agreements Not to Compete*, “[c]ovenants of this type comprise one of the traditional common-law ‘restraints of trade’ and present problems which have kept them before the courts for more than five hundred years.”⁵⁶ Specifically, courts and policymakers have long understood that they “diminish competition by intimidating potential competitors”⁵⁷ and prevent potential competitors from poaching labor and putting that labor to a more efficient use. Further, by preventing the information sharing that naturally occurs when an employee brings her knowledge and expertise to a new employer, they slow “down the dissemination of ideas, processes, and methods.”⁵⁸ Thus, “from the social point of view,” they “clog the market’s channeling of manpower to employments in which its productivity is greatest.”⁵⁹

One of the most influential studies of the negative growth effects of employee noncompetes was published in 1999 by Stanford professor of law and business, Ronald Gilson. Gilson compared two high-technology industrial districts—California’s Silicon Valley and Massachusetts’s Route 128—to explain why the Silicon Valley thrived while Route 128 did not.⁶⁰ Gilson concluded that Route 128’s use of employment noncompetes impeded innovation and discouraged economic growth.⁶¹ In contrast, “[b]ecause California does not enforce post-employment covenants not to compete, high technology firms in Silicon Valley gain from knowledge

56. Blake, *supra* note 2, at 626.

57. *Id.* at 627.

58. *Id.*

59. *Id.*

60. Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575 (1999).

61. *Id.*

spillovers between firms. These knowledge spillovers have allowed Silicon Valley firms to thrive while Route 128 firms have deteriorated.”⁶²

Gilson’s article was and is extremely influential, and for good reason. It indicates that policies that curtail the use of employment noncompetes can advance the public good by encouraging innovation, facilitating knowledge-sharing, and fostering economic growth.

Further, Gilson’s article provides support for a view of employment noncompetes not simply as a shift of benefits from the public to employers, but as a collective action problem. Employers in Silicon Valley collectively benefited from that region’s knowledge-sharing, innovation, and growth. They benefited by *receiving* employees who brought with them tacit knowledge and know-how gained at their prior jobs. But employers have little control over what agreements govern their prospective employees. Instead, they control what agreements govern their current employees and, with respect to their current employees, employers want to retain employees, inhibit mobility, and prevent knowledge-sharing. If every employer was to select an overall regional culture, one might reasonably expect employers to select the growth-fostering culture of competition. However, since every employer instead only selects its own company policy, it selects the protective regime of noncompetes.⁶³

While Gilson’s article illustrates powerfully how an economy, and even the employers within that economy, are harmed by employment noncompete agreements, significant changes have occurred since 1999. Noncompetes have become more common⁶⁴ and more frequently bind rank-and-file employees.⁶⁵ Mounting evidence indicates that contract law’s formal treatment of noncompete agreements—and thus Gilson’s comparison between an enforcement-hostile regime like Silicon Valley and an enforcement-friendly regime like Route 128—is less important than the actual prevalence and use of noncompete agreements.⁶⁶ And labor economics suggests that employer monopsony-like power—the power of an employer to pay a lower wage than would prevail in a competitive

62. *Id.*

63. See THE WHITE HOUSE, NON-COMPETE AGREEMENTS: ANALYSIS OF THE USAGE, POTENTIAL ISSUES, AND STATE RESPONSES 7 (2016), https://obamawhitehouse.archives.gov/sites/default/files/non-competes_report_final2.pdf [<https://perma.cc/M4LZ-5X4J>]. (“While not necessarily in the interest of *an individual* firm, more rapid dissemination of ideas and technology improvements can have significant positive impacts for the larger regional economy in terms of innovation, entrepreneurship, and attracting more businesses and jobs to a region. Non-competes that stifle mobility of workers who can disseminate knowledge and ideas to new startups or companies moving to a region can limit the process that leads to agglomeration economies.”) (emphasis added).

64. See *supra* notes 26–32 and accompanying text.

65. See *supra* notes 34–36 and accompanying text.

66. See *infra* note 171 and accompanying text.

market⁶⁷—is on the rise.⁶⁸ Each of these developments presents a need to consider how employment noncompetes affect competition in the current United States economy. A recent report by the Council of Economic Advisers and recent economic studies fill this need.

In October 2016, the Council of Economic Advisers issued a report concluding that the extensive use of employment noncompetes and, in particular, the extensive use “among workers who are unlikely to have access to trade secrets” threatens to undermine efficiencies offered by free market competition.⁶⁹ Although the report acknowledges that employment noncompetes “are not always harmful to workers or to growth” and, in some instances, can encourage training and innovation by protecting employers from the risk that their employees will misappropriate their intellectual property, it concludes that “the use of [employment] non-competes in the United States today extends well beyond cases where they are plausibly justified.”⁷⁰

Instead of primarily encouraging training, innovation, or growth, the Council found that “the primary effect of [employment noncompete] agreements is to impede worker mobility and limit wage competition.”⁷¹ Noncompetes “are often used to create or exercise market power” and, in particular, “to solidify [employer] bargaining power vis-à-vis their workers.”⁷² Unfortunately, employers already tend to exert excessive

67. See Hiba Hafiz, *Picketing in the New Economy*, 38 CARDOZO L. REV. 1845, 1870 n.121 (2018), (“Joan Robinson coined the term ‘monopsony’ to describe employer market power over wages.”); *id.* at 1870–71 n.121 (providing citations to more recent accounts of monopsony power); *id.* at 1870 (“In the labor market, monopsonistic employers can pay lower wages to workers than would otherwise prevail in a competitive market without losing those workers to competing employers.”).

68. See *infra* note 78 and accompanying text; Hafiz, *supra* note 67, at 1871–72 & n.128 (“Economists and policymakers increasingly recognize the existence of employer monopsony power in labor markets based on direct evidence of collusion between employers and non-compete agreements, as well as indirect evidence of minimum wage impacts on employment, wage-setting, and wage discrimination.”); *id.* at 1872 (“Beginning in the 1990s, economists began finding that minimum wage increases were not accompanied by job loss, indicating that wages have not been bid up to the marginal value of labor.”).

69. COUNCIL OF ECON. ADVISERS, LABOR MARKET MONOPSONY: TRENDS, CONSEQUENCES, AND POLICY RESPONSES 8 (Oct. 2016), https://obamawhitehouse.archives.gov/sites/default/files/page/files/20161025_monopsony_labor_mrkt_cea.pdf [<https://perma.cc/MT2S-F8SG>].

70. *Id.* at 5.

71. *Id.*

72. *Id.* at 8.

bargaining power. In the current American labor market, employers often pay lower-than-efficient wages⁷³ due to high costs and frictions of changing jobs,⁷⁴ a lack of transparency about the competing wages and benefits offered by various jobs,⁷⁵ an erosion of the minimum wage,⁷⁶ and a decline in unions and collective bargaining.⁷⁷ Considering employment noncompetes in the context of the modern American labor market, the Counsel concluded that “employers may be better able to exercise monopsony power today than they were in past decades.”⁷⁸

When employers artificially depress wages, they also depress economic output. Employment noncompetes, like other “forces that undermine competition[,] tend to reduce efficiency, and can lead to lower output, employment, and social welfare.”⁷⁹ For example, they “can lead to inefficient reductions in employment and output, where some workers who would have been willing to work at the competitive market wage are never hired, and the output they would have produced is produced less efficiently by other firms if at all.”⁸⁰

Recent academic research supports the Council of Economic Advisers’ conclusion that the anti-competitive harms of employment noncompete agreements outweigh their potentially pro-competitive benefits. For example, a study on *Noncompetes and Employee Mobility* found that noncompetes inhibit job mobility and increase frictions that prevent employees from moving to higher paying positions.⁸¹ As the researchers explain:

Noncompetes function to create additional moving costs when the [new job] offer is from a competitor—whether in the form of guilt, fear of litigation, or potential delay. As a result, noncompetes increase the threshold wage a competitor must offer to induce movement, reducing the likelihood that the employee will accept [a

73. See *supra* note 68 (providing evidence that in the current labor market, wages are artificially depressed).

74. COUNCIL OF ECON. ADVISERS, *supra* note 69, at 4 (“But importantly, wage-setting power can also occur naturally—even in markets with many employers— due to frictions that limit workers choices or mobility.”).

75. *Id.* at 14.

76. *Id.* at 13 (“[T]he real value of the Federal minimum wage has declined 24 percent since its peak of \$9.55 (in 2015 dollars) in 1968 . . .”).

77. *Id.* at 12–13 (“[U]nion membership has declined consistently since the 1970s. . . . Research suggests that declining unionization accounts for between a fifth and a third of the increase in [wage] inequality since the 1970s.”).

78. *Id.* at 10.

79. *Id.* at 1.

80. *Id.* at 3.

81. Evan Starr, J.J. Prescott & Norman Bishara, *Noncompetes and Employee Mobility* (Univ. of Mich. Law & Econ., Research Paper No. 16-032, 2016) (on file with author). Paper cited with permission of the authors.

new job offer].⁸²

To the extent that a new job offers higher compensation because it puts the employee's skills to a higher, better use, labor productivity is lost due to the noncompete.

Additional studies indicate that employment noncompetes negatively interfere with markets. They “limit entrepreneurship,”⁸³ “impede innovation,”⁸⁴ cause entrepreneurial employees to open businesses in industries that are unrelated to their past jobs rather than taking maximum advantage of knowledge learned and skills developed in their past jobs,⁸⁵ cause affluent employees to place themselves on “involuntary sabbatical[s]” to wait out the term of the noncompete,⁸⁶ cause employees who violate or arguably violate their noncompetes to “withdr[aw] from professional contacts in order that they might remain undetected,”⁸⁷ and are associated with wage suppression that persists over the course of a worker's career even if the worker changes jobs or relocates across state lines.⁸⁸ Noncompetes are associated with employees investing less in their own

82. *Id.* at 14.

83. Sampsa Samila & Olav Sorenson, *Noncompete Covenants: Incentives to Innovate or Impediments to Growth*, 57 MGMT. SCI. 425, 428 (2011), <https://doi.org/10.1287/mnsc.1100.1280>; see also LOBEL, *supra* note 26, at 350 (explaining that restricting employee mobility “stymies the entry of new competitors into the market and suppresses the spirit of entrepreneurship which is vital to any economy”).

84. Samila & Sorenson, *supra* note 83, at 428.

85. Evan Starr, Natarajan Balasubramanian & Mariko Sakakibara, *Screening Spinouts? How Noncompete Enforceability Affects the Creation, Growth, and Survival of New Firms*, 64 MGMT. SCI. 552 (2018), <https://doi.org/10.1287/mnsc.2016.2614>.

86. Matt Marx & Lee Fleming, *Non-Compete Agreements: Barriers to Entry . . . and Exit?*, in 12 NAT'L BUREAU OF ECON. RESEARCH, INNOVATION POLICY AND THE ECONOMY 39, 50 (Josh Lerner & Scott Stern eds., Univ. of Chi. Press 2012), <http://www.nber.org/chapters/c12452.pdf>.

87. *Id.*

88. Natarajan Balasubramanian et al., *Locked In? The Enforceability of Covenants Not to Compete and the Careers of High-Tech Workers* 30 (Ross Sch. of Bus., Paper No. 1339, 2018), <https://ssrn.com/abstract=2905782> (“[W]e also find that compared with their peers in low-enforceability states, workers in states with high enforceability receive reduced wages throughout a given job as well as over their career.”); *id.* at 15 & 51 (explaining that the “persistent wage suppressing effect” of noncompetes and the reduced bargaining power they provide employees “offset[s] potential gains to the employee” of a noncompete, like training or increased employer investment in the employee); *id.* at 32 (“Our last finding . . . [regarding the effects of covenant not to compete (CNC)] enforceability over the career of the employee suggests that [simply] starting a job in a higher enforceability state—regardless of whether the individual eventually leaves that state—is associated with reduced earnings up to eight years later. . . . [O]ur results strongly suggest that CNC enforceability lowers worker welfare . . .”).

training and human capital⁸⁹ and performing lower quality work.⁹⁰ At least one study indicates that the negative effects of employment noncompetes spill over to “unconstrained” workers (those not bound by noncompetes) by causing market-wide reductions to job offer rates, job mobility rates, and prevailing wages.⁹¹

2. Negative Distributional Effects

Long before the media accounts of Amazon and Jimmy John’s, courts recognized the potential that employers would use noncompetes to exploit their workers, especially their lower-paid or vulnerable workers. For example, in a 1952 case about Arthur Murray Dance Studios subjecting its dance instructors to noncompetes, the court recognized that “[t]he average, individual employee has little but his labor to sell or to use to make a living. He is often in urgent need of selling it and in no position to object to boiler plate restricted covenants placed before him to sign.”⁹² The less resources a worker has, the less able he is to resist a noncompete.

This concern is reinforced by the Council of Economic Advisers’ report. The report not only concludes that firms with monopsony power are able to exploit that power to “pay lower wages”⁹³ and “shift some of the benefits of production from wages to profits,”⁹⁴ it concludes that this phenomenon is at least partially to blame for “slow wage growth and rising inequality” in the current U.S. labor market.⁹⁵

The report warns that noncompetes decrease the correlation between wages and productivity and increase the correlation between wages and bargaining power.⁹⁶ In an efficient wage market, “each firm will bid up the wage to recruit workers from other firms as long as the revenue it can earn by hiring another worker exceeds the wage it must pay—establishing a close link between wages and worker productivity.”⁹⁷ However, monopsony

89. Mark J. Garmaise, *Ties that Truly Bind: Noncompetition Agreements, Executive Compensation, and Firm Investment*, 27 J. L. ECON. & ORG. 376, 413–14 (2011); On Amir & Orly Lobel, *Driving Performance: A Growth Theory of Noncompete Law*, 16 STAN. TECH. L. REV. 833, 846 (2013).

90. Amir & Lobel, *supra* note 89, at 863 (observing decline in quality of work of restricted employees).

91. Evan Starr, Justin Frake & Rajshree Agarwal, *Mobility Constraint Externalities: How Noncompetes Shackle the Unconstrained* 29 (2018), <https://ssrn.com/abstract=3027715>.

92. *Arthur Murray Dance Studios of Cleveland, Inc. v. Witter*, 105 N.E.2d 685, 703–04 (Ohio Ct. Com. Pl. of 1952).

93. COUNCIL OF ECON. ADVISERS, *supra* note 69, at 15.

94. *Id.* at 2.

95. *Id.* at 1.

96. *Id.*

97. *Id.* at 2; *see also id.* at 9 (“Economic theory suggests that in competitive markets, wages are . . . bid up until they just equal the marginal value of labor to the firm . . .”).

power, which employment noncompetes foster, prevents wages from being bid up to near the worker productivity line and “opens up the possibility that wages can differ—both between and within firms—even among workers with similar skills.”⁹⁸ Workers are not paid based on what their labor is worth but based on what they will accept. Thus,

if employers with monopsony power are able to differentiate among workers’ reservation wages, then they can also set wages that discriminate among their own employees[,] . . . pay[ing] each worker the minimum he or she is willing to accept, regardless of the worker’s skills or productivity. More generally, differing degrees of worker bargaining power across different groups of workers—for example by age, race or gender—may lead to varying degrees of wage depression, promoting within-firm wage inequality. For example, if women’s job mobility is more constrained than men’s by family responsibilities, then women will be more limited in their choice of employers and be more vulnerable to wage discrimination.⁹⁹

Among employees already bound by noncompetes, an employer’s power will be greatest against employees who do not have meaningful access to legal counsel, are unwilling to aggressively challenge the enforceability of a noncompete, or are unwilling or unable to move out of the geographically restricted area for more lucrative employment.¹⁰⁰

98. *Id.* at 3.

99. *Id.* at 3; *see also* Hafiz, *supra* note 67, at 1894 (“[M]onopsonistic wage-setting can also weaken the link between labor productivity and wages because when firms no longer compete aggressively for workers, wages differ between and within firms, and even among workers with similar skills. These ‘differing degrees of worker bargaining power across different groups of workers . . . may lead to varying degrees of wage depression [and] within-firm inequality[,]’ particularly for workers in protected classes under the employment discrimination laws.”) (alterations in original except the first) (footnotes omitted) (quoting ALAN MANNING, *MONOPSONY IN MOTION: IMPERFECT COMPETITION IN LABOR MARKETS* 4 (2003)).

100. COUNCIL OF ECON. ADVISERS, *supra* note 69, at 9 (noting that women may be disproportionately harmed by employment noncompetes because “domestic responsibilities [more] often act as a constraint on women’s job search”).

Finally, while the Author is unaware of studies on this question, it seems reasonable to fear that employment noncompetes may prevent victims of workplace harassment from perceiving or using exit options.¹⁰¹

3. *Negative Ethical Effects*

Of course, there are negative ethical implications to all the harms already described: interfering with economic markets, stifling growth, slowing innovation, inhibiting labor mobility, worsening monopsonies, depressing wages, contributing to income inequality, and particularly harming vulnerable workers. The purpose of this section is to suggest that while some harms of employment noncompetes are primarily economic, and some primarily distributional, there are also primarily ethical harms. Employment noncompetes undermine shared values of personal freedom and fairness.¹⁰² As Harlan Blake recognized,

Every postemployment restraint, for whatever reason imposed, has inevitable effects which in some degree oppose commonly shared community values. In view of our feeling that a man should not be able to barter away his personal freedom, even this small degree of servitude is distasteful. It is particularly distasteful if there is no effective bargaining between the parties—as in the situation in which the employer knows that everyone else in the industry insists on the covenant too, or when the employment officers have no authority to change the provisions of the employment contract form. The values offended are more social or political than economic.¹⁰³

101. See also Joe Biden, *We Heard Your Stories. It's Time to #LetUsCompete*, MEDIUM (Oct. 25, 2016) <https://medium.com/@VPOTUS44/we-heard-your-stories-its-time-to-letuscompete-1b440782a8ae> [<https://perma.cc/M4PQ-EE7B>] (“I heard from a woman in Ohio who, after having the courage to leave an abusive marriage, was threatened with lawsuits for taking an entry-level sales job at a new company.”); *Variable Annuity Life Ins. Co. v. Laeng*, No. 8:12-cv-2280-T-33MAP, 2013 WL 499982, at *3 (M.D. Fla. Jan. 2, 2013) (finding “no controlling authority” to support former employee’s claim that she was relieved of the obligation to comply with an employment noncompete because her former employer “allowed one of its employees to sexually assault and harass [her], failed to investigate those claims, created a hostile work environment, and retaliated against her by constructive discharge.”).

102. While this section describes ethical harms of employment noncompetes, its purpose is not to take a position on the question of whether and when these ethical harms are sufficiently serious to justify setting aside otherwise valid contracts because they are employment noncompetes. Because this Article’s proposal does not set aside noncompetes, it does not present that question.

103. Blake, *supra* note 2, at 650.

Employment noncompetes trade freedoms that we are uncomfortable being the subject of exchange,¹⁰⁴ particularly when the exchange is less than fully free.¹⁰⁵

These ethical concerns are heightened due to “the profound changes that are occurring in the employment relationship in the United States.”¹⁰⁶ As Professor Katherine Stone traces, “[f]irms are dismantling their internal labor markets and abandoning their implicit promises of orderly promotion and long-term job security. No longer is employment centered on a single, primary employer.”¹⁰⁷

Employers, who no longer offer “implicit promises of job security,”¹⁰⁸ now seek to attract, retain, and motivate employees by implicitly promising them *employability security*. They promise to provide employees training, skill development, and professional network building that will make them

104. See, e.g., *Mandeville v. Harman*, 7 A. 37, 38 (N.J. Ch. 1886) (“[N]o principle of law is more generally recognized than that a contract which precludes a person from the right to employ his talents, his industry, or his capital, in any useful undertaking, is void.”); *id.* at 40 (“Professional skill, experience, and reputation are things which cannot be bought or sold. They constitute part of the individuality of the particular person, and die with him.”); *id.* at 40–41 (describing skill, ability, and professional practice as things “so purely personal” that they “can have neither an intrinsic nor a market value.”); *id.* at 41 (“It is one of the natural rights of every citizen of this state to use his skill and labor in any useful employment, not only to get food, raiment, and shelter, but to acquire property; and I think it may be regarded as very certain that the courts will never deprive any one of this right, or even abridge it, except in obedience to the sternest demands of justice.”). For a summary of the broader debate about what valuable assets should and should not be permissibly sold, see, e.g., Note, *The Price of Everything, the Value of Nothing: Reframing the Commodification Debate*, 117 HARV. L. REV. 689 (2003).

105. Employment noncompetes are often executed under conditions lacking procedural fairness. See, e.g., OFFICE OF ECON. POLICY, U.S. DEP’T OF TREASURY, *supra* note 27, at 12–13 (citing a survey of “members of the Institute of Electrical and Electronics Engineers” finding that “barely [30% of] workers reported that they were told about the non-compete in their job offer,” while “[i]n nearly 70% of cases, the worker was asked to sign the non-compete after accepting the offer—and, consequently, after having turned down (all) other offers.”); *id.* at 13 (citing a different survey finding that “only 10 percent of workers with non-competes report bargaining over [any terms in] their non-compete, with 38 percent of non-bargainers not realizing that they could even negotiate.”).

106. Katherine V.W. Stone, *The New Psychological Contract: Implications of the Changing Workplace for Labor and Employment Law*, 48 UCLA L. REV. 519, 519 (2001). See also Kenneth G. Dau-Schmidt, *Employment in the New Age of Trade and Technology: Implications for Labor and Employment Law*, 76 IND. L.J. 1, 1 (2001) (explaining that globalization and the rapid pace of technological innovation has “undermined long-term employment relationships and brought the market into the firm in ways that have not previously been experienced”).

107. Stone, *supra* note 106, at 519.

108. *Id.* at 524.

marketable to future employers.¹⁰⁹ In the current labor market, the “promise of employability security . . . is treated as a substitute for the former promise of employment security.”¹¹⁰ Thus, employees who change jobs now reasonably expect to continue to reap the rewards of their training, skill development, and even networks with new employers.¹¹¹ As Stone argues, courts should uphold these expectations. “When employers argue for enforcement of noncompete covenants . . . courts should inquire as to whether the promise of general training was expressly or tacitly part of the employment deal. If it was, then they should not restrain employees from subsequently using the knowledge so obtained.”¹¹²

In the current labor market, an employee’s use of her training to benefit future employers is not an act of disloyalty; it is an act of necessity. As a result, an employer’s effort to prevent that use is not an act of reasonable self-protection; it is an act of unfairness. Employers no longer offer their employees long-term employment and can no longer demand that their employees forfeit skills or value when the employment relationship ends. As Stone explains,

[U]nder the new employment contract, employees have been promised not only training, upskilling, and networking, but also the ability to use their newly acquired skills in subsequent employment. Networking, training, and lateral mobility are a fundamental aspect of today’s employment system. While individual employers may have an incentive to offer these benefits and then renege, the courts should not support them in doing so.¹¹³

Fairness in the current labor market is best achieved if employees are able to leave their jobs equally or more marketable than when they started them. Noncompetes undermine fairness in the labor market by inhibiting a worker’s ability to take her newly acquired skills to a new job. This ability is particularly important when a worker’s current employer does not offer advancement opportunities, seniority benefits, or long-term employment prospects.

109. *See id.* at 590–91 (“[E]mployers in today’s workplace often promise to provide general training as part of the new psychological contract. One of the most important terms of the new psychological contract is the employers’ promise of general training and employability security in exchange for employee motivation, commitment, and organizational citizenship behavior. Employers also promise to provide general training in order to attract applicants. Thus, many firms offer to pay for some types of employee education as an inducement for recruitment.”).

110. *Id.* at 525.

111. *Id.* (“[T]raining and skill development are part of the employment deal, [thus] employees who leave firms to take other jobs should be able to take their general human capital with them.”).

112. *Id.* at 591.

113. *Id.* at 592.

C. State Responses

This Article does not aim to detail the various state law responses to employment noncompetes. Detailed accounts are available elsewhere, including in online resources that account for rapid change.¹¹⁴ Rather, it aims to show that states have used a wide variety of contract-law-based responses to employment noncompetes. In their work as “laboratories of democracy,”¹¹⁵ conducting “novel social and economic experiments,”¹¹⁶ states have tested a variety of approaches. Unfortunately, their experience demonstrates that contract-law-based approaches, no matter the form, have proven to be inadequate and largely unsuccessful. What no state has done is to test a tax-law-based approach to curtailing noncompetes, like the one proposed in this Article.

States have attempted to limit the harms caused by employment noncompetes by implementing resistance grounded in contract law. California,¹¹⁷ North Dakota,¹¹⁸ and Oklahoma¹¹⁹ generally prohibit judicial enforcement of employment noncompetes. Many other states will only enforce an employment noncompete if it is supported by separately stated

114. See, e.g., Beck Reed Riden LLP, *Employee Noncompetes: A State by State Survey*, FAIR COMPETITION L. (July 11, 2017), <https://www.faircompetitionlaw.com/wp-content/uploads/2017/07/Noncompetes-50-State-Survey-Chart-20170711.pdf> (providing a fifty-state survey of employment noncompete laws updated by the law firm, Beck Reed Riden); SEYFARTH SHAW, 50 STATE DESKTOP REFERENCE: WHAT EMPLOYERS NEED TO KNOW ABOUT NON-COMPETE AND TRADE SECRETS LAW (2016), http://www.seyfarth.com/uploads/siteFiles/practices/141926_ChartofTradeAgreementsbyState_Final.pdf (providing a fifty-state survey of employment noncompete laws updated by the law firm, Seyfarth Shaw).

115. “Laboratories of democracy” is a phrase made famous by Supreme Court Justice Louis Brandeis’s dissent in *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (“[A] single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.”).

116. *Id.*

117. See CAL. BUS. & PROF. CODE §§ 16600, 16601, 16602, and 16602.5 (2018) (prohibiting employment noncompetes with narrow exceptions).

118. N.D. CENT. CODE § 9-08-06 (2017).

119. OKLA. STAT. tit. 15, § 219A (2018).

consideration.¹²⁰ New Hampshire¹²¹ and Oregon¹²² will only enforce an employment noncompete if the prospective employee was given sufficient notice that she would be subject to an employment noncompete prior to accepting her job offer. Other states will only enforce a noncompete if the restricted period is less than a state-imposed cap of twelve months¹²³ or eighteen months¹²⁴ or twenty-four months¹²⁵ or will reduce durations that exceed those caps.¹²⁶ Other states have established time limits for employment noncompetes within which they are presumed reasonable and beyond which they are presumed unreasonable.¹²⁷ Others will enforce employment noncompetes only against certain categories of workers, like highly-compensated employees with access to inside information,¹²⁸ or will refuse to enforce noncompetes against other categories of workers, like health care workers or low-income workers.¹²⁹ Some states will refuse to enforce noncompetes against discharged employees¹³⁰ or employees discharged without cause.¹³¹ Most states will only enforce a noncompete if it is judicially determined to be reasonable in duration, scope, and geographic reach, or will rewrite overly broad restrictions to meet these reasonableness standards.¹³²

120. See, e.g., Beck Reed Riden LLP, *supra* note 114 (showing separately stated and sometimes “adequate” consideration required in Kentucky, Minnesota, Montana, North Carolina, Oregon, Pennsylvania, South Carolina, Texas, West Virginia, and Wyoming). Note that even when the consideration must be separately stated, it can still come in the form of compensation, a bonus, or a raise.

121. N.H. REV. STAT. ANN. § 275:70 (2018) (providing New Hampshire’s notice requirement).

122. OR. REV. STAT. § 653.295(1)(a)(A) (2017) (providing Oregon’s notice requirement).

123. See, e.g., UTAH CODE ANN. § 34-51-201 (LexisNexis 2018) (limiting noncompetes in Utah to twelve months).

124. See, e.g., OR. REV. STAT. § 653.295(2) (limiting noncompetes in Oregon to eighteen months).

125. See, e.g., S.D. CODIFIED LAWS § 53-9-11 (2018) (limiting noncompetes in South Dakota to 24 months); LA. STAT. ANN. § 23:921C (2018) (limiting noncompetes in Louisiana to twenty-four months).

126. See, e.g., Beck Reed Riden LLP, *supra* note 114 (showing states that couple time limit with reformation doctrine).

127. See, e.g., IDAHO CODE §§ 44-2701, -2704 (2018) (providing that Idaho requires noncompetes be reasonable and establishing that an 18-month duration is rebuttably presumed reasonable).

128. See, e.g., §§ 44-2701 to -2702 (providing that employment noncompetes will only be enforced as to specified “key employees”).

129. See, e.g., N.H. REV. STAT. ANN. § 329:31-a (2018) (excepting physicians from noncompete enforcement); N.M. STAT. ANN. §§ 24-11-1 to -5 (2018) (excepting health care practitioners); MO. ANN. STAT. § 431.202(4) (West 2001) (excepting clerks and secretaries); Illinois Freedom to Work Act, 820 ILL. COMP. STAT. 90/1–90/10 (2017) (excepting workers who earn less than the greater of: (i) the federal, state, or local minimum wage or (ii) \$13.00 per hour).

130. SEYFARTH SHAW, *supra* note 114 (listing as jurisdictions that will not enforce noncompetes against discharged employees the District of Columbia, Maryland, and Montana).

131. *Id.* (listing as jurisdictions that will not enforce noncompetes against employees discharged without cause Illinois and New York).

132. See, e.g., T. Leigh Anenson, *The Role of Equity in Employment Noncompetition Cases*, 42 AM. BUS. L.J. 1, 17 (2005) (“[T]he English rule of reason remains the doctrinal scheme in a majority of states in this country.”); Maureen B. Callahan, Comment, *Post-Employment Restraint Agreements: A Reassessment*, 52 U. CHI. L. REV. 703, 709 (1985) (noting that the English rule of reason from *Mitchell v. Reynolds* “has survived virtually unchanged to the present day”); Beck Reed Riden LLP, *supra* note

D. Federal Responses

Contract law is primarily a matter of state law. Thus, federal responses to employment noncompetes have mainly aimed to gather and disseminate information and encourage states to pass laws to curtail employment noncompetes.

On October 25, 2016, the Obama White House announced an initiative to increase competition in the labor market.¹³³ As part of this initiative, it surveyed data on the use and prevalence of employment noncompetes,¹³⁴ reported on the various state law responses to employment noncompetes,¹³⁵ and distributed a Call to Action asking states to do more to constrain employment noncompetes,¹³⁶ particularly as they apply to lower-wage employees.¹³⁷

114 (tracking reasonableness requirements and states that allow judicial revision of unreasonable noncompetes via reformation doctrines, which allow courts to rewrite unreasonable provisions, or blue-pencil doctrines, which allow courts to strike unreasonable provisions and retain the rest of the contract).

133. Office of the Press Secretary, *Fact Sheet: The Obama Administration Announces New Steps to Spur Competition in the Labor Market and Accelerate Wage Growth*, THE WHITE HOUSE (Oct. 25, 2016), <https://obamawhitehouse.archives.gov/the-press-office/2016/10/25/fact-sheet-obama-administration-announces-new-steps-spur-competition> [<https://perma.cc/4KB4-LDXG>].

134. See THE WHITE HOUSE, *supra* note 63, at 2.

135. THE WHITE HOUSE, NON-COMPETE REFORM: A POLICYMAKER'S GUIDE TO STATE POLICIES 1 (Oct. 2016), https://obamawhitehouse.archives.gov/sites/default/files/competition/state-by-statenoncompetesexplainer_unembargoedfinal.pdf [<https://perma.cc/AAT5-ZBHG>] (providing information on state policies related to non-compete agreements as of October 2016).

136. *State Call to Action on Non-Compete Agreements*, THE WHITE HOUSE 1–2, <https://obamawhitehouse.archives.gov/sites/default/files/competition/noncompetes-calltoaction-final.pdf> [<https://perma.cc/3K8R-KHS2>]; Office of the Press Secretary, *supra* note 133 (“Non-compete agreements narrow the employment options for an estimated one in five workers in the United States. As the White House and Treasury reported earlier this year, there is substantial evidence of overuse and misuse of these clauses. Today, the Administration put out a call to action and set of best practices for state policymakers to enact reforms to reduce the prevalence of non-compete agreements that are hurting workers and regional economies.”)

137. Office of the Press Secretary, *supra* note 133. This encouragement followed the administration's conclusion that “[a] considerable proportion of non-compete agreements signed by both low- and high-wage workers come at the expense of wage growth, entrepreneurship, and broader economic growth.” *Id.* See also *White House Urges Ban on Non-Compete Agreements*, NBC NEWS (Oct. 26, 2016, 7:28 AM), <https://www.nbcnews.com/business/business-news/white-house-urges-ban-non-compete-agreements-n673061> [<https://perma.cc/64NT-Q2NN>] (quoting then Vice President Joseph Biden's statement that workers “can't reach their true potential without freedom to negotiate for a higher wage with a new company, or to find another job . . .”).

Specifically, the Obama White House asked state policymakers to pursue one or more of the following “best-practice policy objectives”:

1. Ban non-compete clauses for categories of workers, such as workers under a certain wage threshold; workers in certain occupations that promote public health and safety; workers who are unlikely to possess trade secrets; or those who may suffer undue adverse impacts from non-competes, such as workers laid-off or terminated without cause.
2. Improve transparency and fairness of non-compete agreements by, for example, disallowing non-competes unless they are proposed before a job offer or significant promotion has been accepted (because an applicant who has accepted an offer and declined other positions may have less bargaining power); providing consideration over and above continued employment for workers who sign non-compete agreements; or encouraging employers to better inform workers about the law in their state and the existence of non-competes in contracts and how they work.
3. Incentivize employers to write enforceable contracts, and encourage the elimination of unenforceable provisions by, for example, promoting the use of the “red pencil doctrine,” which renders contracts with unenforceable provisions void in their entirety.¹³⁸

The Obama White House also called “on Congress to pass federal legislation to eliminate non-competes for workers under a certain salary threshold”¹³⁹ While various members of Congress proposed bills to carry out this directive,¹⁴⁰ no such bill has passed.

Importantly, even if one or more of the best-practice policy objectives were implemented at the national level, there is reason to fear that it would not sufficiently curtail the damaging use of employment noncompetes. Each of the proposed policy objectives has been tested at the state level,¹⁴¹

138. Office of the Press Secretary, *supra* note 133.

139. *Id.*

140. See, e.g., Mobility and Opportunity for Vulnerable Employees Act (MOVE Act), S. 1504, 114th Cong. (2015); see also Limiting the Ability to Demand Detrimental Employment Restrictions Act (LADDER Act), H.R. 2873, 114th Cong. (2015). On April 26, 2018, Senators Christopher Murphy, Elizabeth Warren, and Ron Wyden co-sponsored the Workforce Mobility Act of 2018, S. 2782, 115th Cong. (2018) to prohibit employers from requiring their employees to sign noncompete agreements. That Act was referred to the Senate Committee on Health, Education, Labor, and Pensions. A House version of the Workforce Mobility Act of 2018, H.R. 5631, was introduced on April 26, 2018.

141. See *supra* notes 117–132 and accompanying text (showing that various states restrict noncompetes in the ways suggested by best-practice policy objectives, even before these objectives were

and the most extensive survey of noncompete use indicates that no state has yet effectively curtailed the damaging use of noncompetes.¹⁴²

II. WHY CONTRACT LAW IS A WEAKER APPROACH

To be clear, this Article does not aim to dissuade lawmakers from using contract-law-based approaches to curtail employment noncompetes. Employment noncompetes are currently used in excessive and harmful ways, and it is appropriate that the law seek to restrain them. However, in light of data indicating that “employer behavior appears, at first blush, to be invariant to noncompete enforceability”¹⁴³ and that changes to contract law do not meaningfully reduce the prevalence of noncompetes, this Article proposes a tax-law-based approach and argues that it holds the potential of being more effective than the contract-law-based approaches employed to date. This Part identifies several reasons that contract law has failed adequately to curtail employment noncompetes in an effort to anticipate whether tax law is likely to suffer—or instead might avoid—similar failures.

A. Tension with Contract Law Principles

Foundational principles of contract law support upholding written agreements between competent consenting adults. The freedom to contract—and to have contracts upheld—is “a central value of the liberal economic philosophy [that] permitted men of sound mind to enter arrangements as they saw fit.”¹⁴⁴ Freedom to contract principles encourage courts to uphold employment noncompete agreements.¹⁴⁵ Additionally, freedom to contract principles often trump other public policy considerations. As the early noncompete case, *Printing & Numerical Registering Co. v. Sampson*, warns,

published). See also THE WHITE HOUSE, *supra* note 135, at 8 (showing that Nebraska, Nevada, South Carolina, Virginia, and Wisconsin already use the red pencil doctrine).

142. Prescott, Bishara & Starr, *supra* note 1, at 376–77.

143. *Id.* at 462.

144. OFFICE OF ECON. POLICY, U.S. DEP’T OF TREASURY, *supra* note 27, at 30.

145. *Id.* (citing *Rousillon v. Rousillon*, 14 Ch. D. 351 (1880)).

It must not be forgotten that you are not to extend arbitrarily those rules which say that a given contract is void as being against public policy, because if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice. Therefore, you have this paramount public policy to consider—that you are not lightly to interfere with this freedom of contract.¹⁴⁶

Thus, as the Second Restatement of Contracts observes, “In general, parties may contract as they wish, and courts will enforce their agreements without passing on their substance.”¹⁴⁷

Many contract-law-based approaches to curtailing employment noncompetes are in tension with this foundational principle of freedom to contract. They seek to set aside otherwise valid written contracts entered into by competent consenting adults because they apply to the wrong class of worker, are for the wrong duration, or are for the wrong geographic area. Neither the contract nor the contracting parties decide what constitutes wrong. In the cases of California and North Dakota, employment noncompetes are set aside because their subject matter is wrong, regardless of their terms. That contract-law-based approaches require setting aside otherwise valid written contracts puts these approaches in tension with contract law’s foundational freedom of contract principle.

This tension likely explains why a judge who finds a noncompete to be unenforceable often takes the additional step of acting, via the reformation doctrine or blue pencil doctrine, to cure defects in these contracts so that they can then be upheld.¹⁴⁸ The effort to save even unlawful noncompetes likely reflects a disposition to enforce contracts freely entered. This disposition undermines contract law’s effectiveness in curtailing noncompetes and encourages employers to continue writing broad and even unenforceable noncompetes.

Similarly, foundational principles of contract law focus on the shared intent of the contracting parties and consider third-party or broader social

146. Blake, *supra* note 2, at 640–41 (citing *Printing & Numerical Registering Co. v. Sampson*, L.R. 19 Eq. 462, 465 (1875)).

147. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS ch. 8, intro. note (AM. LAW INST. 1981).

148. See, e.g., *Prod. Action Int’l, Inc. v. Mero*, 277 F. Supp. 2d 919, 932 (S.D. Ind. 2003) (suggesting that the blue pencil doctrine was adopted because it facilitates courts upholding covenants not to compete); *Cent. Adjustment Bureau, Inc. v. Ingram*, 678 S.W.2d 28, 37 (Tenn. 1984) (suggesting that equitable reformation doctrine was adopted because it is consistent with contract law principles and upholds intentions of the parties better than nonenforcement); *Davies & Davies Agency, Inc. v. Davies*, 298 N.W.2d 127, 131 n.1 (Minn. 1980) (suggesting that the blue pencil doctrine was adopted because it enables courts to make changes to the terms of a noncompete without having to strike it down).

interests only reluctantly.¹⁴⁹ In theory, contracts only affect the parties who sign them. However, employment noncompetes affect third-party and broader social interests in unusually significant ways. For example, they can prevent prospective employers from hiring desired workers and they deprive society of efficient labor markets. Employment noncompetes affect third-party interests and broader social interests in a way that contract law has difficulty taking into full account. In a dispute to uphold or set aside an employment noncompete, will prospective employers be allowed to intervene? What mechanisms does the public have to finance or encourage litigation opposing unlawful or excessive noncompetes?¹⁵⁰ Even when third-party and public interests are significant and legitimate, contract law has difficulty fully accounting for them.

Finally, contract law is reluctant to second-guess the adequacy of consideration or the fairness of substantive contract terms. As the 1858 case, *Westlake v. Adams*, states, “[i]t is an elementary principle that the law will not enter into an inquiry as to the adequacy of the consideration.”¹⁵¹ In the rare times when a typical contract fails for lack of consideration, the consideration is not merely inadequate or unfair, it is an “absurdity”¹⁵² or a “joke.”¹⁵³ That a contract is valid even when one party to a contract might promise something valuable while the other party promises something far, far less valuable is so widely acknowledged that it is known as the “peppercorn theory” of consideration.¹⁵⁴ However, contract law’s reluctance to second-guess the adequacy of consideration is difficult to reconcile with the requirement that noncompetes be reasonable. Even a narrowly-tailored restriction is unreasonable if the restricted party receives no or only de minimis value in exchange for enduring it. Thus, courts set aside employment noncompetes for lack of adequate consideration in a way

149. See, e.g., *supra* note 146 and accompanying text.

150. The State Attorney General suit against Jimmy John’s is one example of publicly financed opposition to employment noncompetes, but these examples are rare. See *supra* notes 42–54 and accompanying text.

151. Edmund Polubinski, Jr., *The Peppercorn Theory and the Restatement of Contracts*, 10 WM. & MARY L. REV. 201, 201 (1968) (quoting *Westlake v. Adams*, 5 C.B. (N.S.) 248 (1858)).

152. *Id.* (quoting *White v. Bluett*, 23 L.J. Ex. 36 (1834)).

153. *Id.* (quoting *Fischer v. Union Trust Co.*, 101 N.W. 852 (Mich. 1904)).

154. *Id.* at 206.

they do not typically set aside other contracts.¹⁵⁵ However, judicial reluctance to declare consideration inadequate or to second-guess the substantive fairness of contract terms likely prevents contract-law-based approaches from successfully curtailing employment noncompetes.

B. Ignores Business Judgment

While employment noncompetes are problematically overused, there may be instances in which an employment noncompete is a valuable and appropriate tool. For example, sophisticated prospective employees with meaningful access to legal counsel and vast employment opportunities may anticipate learning highly-sensitive information from prospective employers. They may wish to negotiate and sign noncompete agreements with prospective employers to encourage these prospective employers to hire and share protected information with them. Indeed, this is the context in which employment noncompetes began. While intellectual property rights might partially protect employers in these scenarios, their partial protection might not always be sufficient. “[I]n certain circumstances such [employment noncompete] covenants are necessary, largely because other legal remedies, although theoretically available, are relatively ineffective in practice.”¹⁵⁶

Unfortunately, contract law is ill-equipped to predefine the circumstances in which an employment noncompete is a valuable and appropriate tool. Unless it is willing to base all decisions on a vague standard—like the existing reasonableness standard—that has led to uncertainty and an overuse of employment noncompetes, contract law faces the formidable challenge of predefining when employment noncompetes should be allowed and with what terms. Should we uphold employment noncompetes for workers whose compensation exceeds a certain threshold? What about founders who are paid primarily in stock? Should we uphold employment noncompetes for workers who are in certain designated management positions? What about managers who access only public information? What about non-managers who research and develop new products?

For reasons that courts have articulated in cases involving the business judgment rule, courts are less capable at making difficult strategic business decisions than are businesses themselves.¹⁵⁷ It is not surprising, therefore,

155. *See, e.g.*, *Wilder v. John Youngblood Motors, Inc.*, 534 S.W.3d 902, 912 (Mo. Ct. App. 2017).

156. *Blake, supra* note 2, at 691.

157. *See, e.g.*, *Brock Built, LLC v. Blake*, 686 S.E.2d 425, 431 (Ga. Ct. App. 2009) (“[T]he business judgment rule is a policy of judicial restraint born of the recognition that [business people] are,

that “[t]here have been many cases of gross misuse of [employment noncompete] covenants in the past, in part because of the failure of many courts to engage in a discriminating analysis of their impact before enforcing them.”¹⁵⁸ Rather than a judicial determination or a policymaker’s guess, the best evidence that a particular employment noncompete is appropriate and justified would be if the employer and the employee agreed to it, if each has full knowledge of all relevant facts, and if each must bear the costs of an overly broad or otherwise unreasonable noncompete. Under current law, employers do not bear these costs. However, if they are made to bear them—for example through a rule (like the one proposed in this Article) that makes it more expensive for them to impose overly broad noncompetes or to impose noncompetes on an overly broad set of employees, then the business judgment of employers and employees can better approximate an efficient outcome. Contract law forfeits the potential benefit of business judgment and requires that either a blanket rule (like a statutory prohibition on enforcing noncompetes) or an ambiguous and uncertain standard (like the judicially-imposed reasonableness standard) attempt to approximate efficient outcomes.

C. *Relies on Private Enforcement*

When employment noncompetes are overly broad or otherwise unenforceable, the employees covered by them are often unaware of their unenforceability. Thus, they abide by them rather than ignoring them or challenging them in court.¹⁵⁹ Further, as the stories of Amazon and Jimmy John’s hint, employers using noncompetes may be less interested—or even disinterested—in their legal enforceability. They may be more interested in

in most cases, more qualified to make business decisions than are judges.”) (quoting *In re The Bal Harbour Club*, 316 F.3d 1192, 1194–95 (11th Cir. 2003)).

158. Blake, *supra* note 2, at 691.

159. See, e.g., OFFICE OF ECON. POLICY, U.S. DEP’T OF TREASURY, *supra* note 27, at 24 (“[W]orkers are often poorly informed about the existence and details of their non-competes, as well as the relevant legal implications. Some employers appear to be exploiting this lack of understanding in ways that harm workers without producing corresponding benefits to society.”); Prescott, Bishara & Starr, *supra* note 1, at 462 (“Employees seem much less likely to be aware of governing noncompete law, and may believe that all contractual language is enforceable.”).

their potential to chill pro-competitive behavior by their current and former employees.¹⁶⁰

Since contract law depends on private enforcement by current and former employees, and since these potential private enforcers are often ill-equipped to challenge overly broad or otherwise unenforceable noncompetes, employers are left with an insufficiently checked incentive to use noncompetes excessively. Thus, they write overly broad noncompetes and impose them on an overly broad population of employees.

Unfortunately, contract law's reliance on private enforcement also worsens the distributional harms of employment noncompetes. As one of the researchers of the Noncompete Survey Project, Evan Starr, explains,

People who have high education levels, who are making lots of money — they're pretty confident about whether they signed [an employment noncompete] or not But people who are relatively low-skilled, people with, let's say, a high school degree or less, or people who earn less than \$40,000 — they're very unsure.¹⁶¹

Employees, and especially lower-income employees, usually have incomplete information about whether they signed an employment noncompete, what its terms mean, and whether its terms are enforceable.

Brendan Lynch, an attorney for Community Legal Services of Philadelphia, says his low-income clients usually have no idea that they agreed to a noncompete clause. They find out after they've left a company, when their ex-employer slaps them with a court order or sends a threatening message to a prospective future employer. . . . Lynch says the noncompete agreements he sees are often written too broadly and wouldn't survive a lawsuit. But most workers obey initial threats rather than going to court over them, he said. "I think there are people who have been affected by this, and it doesn't even occur to them to get a lawyer."¹⁶²

The director of a public interest law firm established to represent home care and hospice workers, William Dombi, agrees. To employers "[t]he strength is in the deterrence, rather than the enforcement."¹⁶³

160. OFFICE OF ECON. POLICY, U.S. DEP'T OF TREASURY, *supra* note 27, at 25 ("Many firms write non-compete contracts that contain unenforceable, overbroad provisions. Given the well-documented worker confusion about these contracts and the very low cost of writing an unenforceable contract, employers can exert a chilling effect on worker behavior even when their contracts are unenforceable.").

161. Quinton, *supra* note 11.

162. *Id.*

163. *Id.*

Employers are often aware of employee confusion regarding noncompete enforceability and exploit it. As the U.S. Department of Treasury explains,

Several pieces of evidence suggest that employers are relying on workers' incomplete understanding of non-compete agreements. First, employers often require that workers sign non-compete agreements even in states that refuse to enforce them. For example, in California, which (with limited exceptions) does not enforce non-compete agreements, the fraction of workers currently under a non-compete is 19 percent, which is slightly higher than the national average.¹⁶⁴

Contract law approaches have failed, in large part, because employees who sign unenforceable noncompetes are often unaware of their unenforceability. Thus, they abide by them, rather than ignoring them or seeking to set them aside. This makes them insufficiently effective private enforcers of contract-law-based restrictions on noncompetes. Recognizing this, employers persist in writing broader noncompetes and in applying noncompetes to broader populations of employees, unconcerned with the matter of whether they are legally enforceable contracts.¹⁶⁵

D. Employer-Friendly Judicial Doctrines

In the rare instances when employees challenge unenforceable noncompete agreements in court, they are often disappointed. Judicial doctrines regarding unenforceable noncompetes strongly favor employers and encourage employers to continue using unenforceable noncompetes.

164. OFFICE OF ECON. POLICY, U.S. DEP'T OF TREASURY, *supra* note 27, at 12.

165. See Prescott, Bishara & Starr, *supra* note 1, at 462–63 (“One possible interpretation—which we only suggest here—is that *actual* enforceability may be unimportant to parties; instead, *perceived* enforceability on the part of employees is what is critical, and the actual content of the law may have little relationship to what employees perceive. Indeed, employers may misinform employees simply by asking them to sign a noncompete, which is something they may be more likely to do whenever there is a chance that an employee might view it as binding, or perhaps even a chance that the employee will subsequently view it as a promise or other expressive device that will likely improve the relationship.”) (footnotes omitted); see also *supra* notes 26, 30, & 31 and accompanying text (showing that employment noncompetes are very common, and are becoming more common).

These doctrines likely reflect the tensions, described previously, between actions to set aside employment noncompetes and foundational contract law principles.¹⁶⁶

In some instances, courts' friendly treatment of even unenforceable noncompete agreements comes in the form of reformation (aka equitable reform), and in other instances, it comes in the form of the blue-pencil doctrine. The reformation doctrine prevails in most states¹⁶⁷ and directs courts to rewrite unenforceable terms in a noncompete agreement to make them enforceable. Courts in reformation states will go so far as to insert new provisions, drafted *sua sponte* or suggested by the employer, to render an otherwise defective employment noncompete "non-defective."¹⁶⁸ Courts in blue-pencil states are nearly as eager to uphold noncompetes. They will "delete [only those specific words or provisions] of a non-compete contract that render it overbroad or otherwise defective" in order to save and enforce the rest of the previously unenforceable noncompete agreement.¹⁶⁹ Given that employees rarely seek to set aside unenforceable employment noncompetes, often abide by unenforceable terms while litigation is pending, and reasonably anticipate that courts will bend over backwards to enforce unenforceable noncompete agreements to the greatest extent possible, it is no surprise that noncompetes have become more common despite contract-law based attempts to curtail them.

E. Empirical Evidence of Failures

Regardless of why contract law has failed—whether it is because efforts to curtail noncompetes using contract law (a) are in tension with fundamental principles of contract law, (b) ignore business judgment, (c) rely on private enforcers who lack capacity or sufficient motive to bring meritorious cases, or (d) trigger judicial doctrines that are too friendly toward and insufficiently punitive of unenforceable noncompetes—the important conclusion is that it has failed.¹⁷⁰

166. See *supra* note 148 (listing decisions from various states in which judges explained that they adopted blue pencil and equitable reformation doctrines to uphold contract law principles).

167. Beck Reed Riden LLP, *supra* note 114 (showing that most of the fifty states use the reformation doctrine of judicially rewriting unenforceable noncompetes to make them enforceable).

168. OFFICE OF ECON. POLICY, U.S. DEP'T OF TREASURY, *supra* note 27, at 14.

169. *Id.*

170. See, e.g., Norman D. Bishara, *Fifty Ways to Leave Your Employer: Relative Enforcement of Covenants Not to Compete, Trends, and Implications for Employee Mobility Policy*, 13 U. PA. J. BUS. L. 751, 780 (2011) (observing "a measurable drift of the aggregate policies in the United States toward greater enforcement"); Michael J. Garrison & John T. Wendt, *The Evolving Law of Employee Noncompete Agreements: Recent Trends and an Alternative Policy Approach*, 45 AM. BUS. L.J. 107, 122–48 (2008) (observing trend in state statutes and common law toward upholding more restrictive covenants).

After completing the largest study of U.S. employment noncompetes, researchers J.J. Prescott, Norman D. Bishara, and Evan Starr present their initial and most important finding:

We find little evidence that the incidence of noncompetition agreements in a state (after controlling for potentially confounding factors) has *any relationship* to the level of enforcement of such agreements in that state. In other words, an employee in California (where noncompetes are prohibited) appears to be just as likely to labor under a noncompete as an employee in Florida (where noncompetes are much more likely to be enforced).¹⁷¹

As they detail,

While our work is preliminary, to our eyes, the pattern that emerges is relatively stark . . . [C]onsiderable variation in the enforceability of noncompetes across states exists, and yet the incidence of these contracts does not appear to vary across diverse enforcement regimes. On average, across all quintiles, about 18% of labor force participants are bound by noncompetition agreement. . . . Non-enforcing states like California and North Dakota, for instance, have an estimated noncompete incidence of approximately 19.3%, which is actually higher than the corresponding level for every enforceability quintile (the highest enforcing quintile has an incidence of 19.0%).

Importantly, if we consider other observable information about respondents—such as age, occupation, and industry—in a regression framework, the substance of the resulting pattern does not change.¹⁷²

Indeed, these findings cause the authors of the study to worry that since past legal reform efforts to curtail noncompetes have failed, future efforts may be futile.

[B]ecause our findings suggest that the status quo legal regime in a state may not matter on the ground (at least in terms of incidence levels), policymakers should be wary of presuming that black-letter-

171. Prescott, Bishara, & Starr, *supra* note 1, at 370 (emphasis added).

172. *Id.* at 460–61 (emphasis omitted).

law reform can be a useful tool to change employer practices. The fact that the frequency of noncompetes in a state appears unrelated to the governing legal regime does not necessarily imply there is also no relationship between noncompete law and employee behavior and outcomes. Even so, our finding does raise the specter that, at some basic level, reflexively curtailing or banning noncompetition agreements in something like the California mold may accomplish much less than many scholars, commentators, and policymakers currently imagine.¹⁷³

This Author is similarly pessimistic that contract-law-based reforms can make a meaningful dent in the prevalence of employment noncompetes. But this Author is much more optimistic that “black-letter-law reform can be a useful tool to change employer practices,” provided a wholly novel approach is taken. No efforts—at either state or federal levels—have been taken to use a tax-law-based approach to reform. Yet a tax law route holds the potential of more effectively curtailing employment noncompetes than the relentlessly but unsuccessfully pursued route of contract law.

F. But Contract Law Offers a Hint to Tax Law

Even though contract law has largely failed to curtail the damaging, excessive, and exploitative use of employment noncompetes, contract-law-based challenges have caused courts across the nation and across the ages to make findings that offer a hint to tax law. When presented with claims by employees that the employment noncompetes they seek to set aside are unsupported by adequate consideration, courts consistently agree with employers. Courts find that the consideration necessary to make an employment noncompete enforceable is provided in the form of employee compensation.

Courts agree with employers when they claim that they adequately compensate employees for noncompete restrictions with enhanced employment benefits. Employers have successfully argued that an employer’s action to hire an employee,¹⁷⁴ to retain an at-will employee,¹⁷⁵

173. *Id.* at 463 (emphasis omitted) (footnotes omitted).

174. *See, e.g.,* *Beta LaserMike, Inc. v. Swinchatt*, No. 18059, 2000 WL 262628, at *5 (Ohio Ct. App. Mar. 10, 2000) (“[A]dequate consideration has been provided in the form of the employment itself.”).

175. *See, e.g., id.* (“[C]ontinued employment of an at-will employee provides adequate consideration for a noncompete agreement.”); *Coastal Unilube, Inc. v. Smith*, 598 So.2d 200, 201 (Fla. Dist. Ct. App. 1992) (same); *JumboSack Corp. v. Buyck*, 407 S.W.3d 51, 55 (Mo. Ct. App. 2013) (same). *But see supra* note 120 (listing states that require separately-stated consideration).

to promote an employee,¹⁷⁶ to pay a salary to an employee,¹⁷⁷ to award a raise to an employee,¹⁷⁸ to pay a bonus to an employee,¹⁷⁹ to grant stock options to an employee,¹⁸⁰ or otherwise to provide or increase compensation to an employee¹⁸¹ constitutes adequate consideration for a noncompete. In each of these cases, the consideration for a noncompete is employment compensation that the employer pays the employee. For example, the Mississippi case of *Frierson v. Sheppard Building Supply Co.*¹⁸² involved an employee who earned \$450 per month plus bonuses for his work as a manager. After he was discharged by his employer and began a competitive business, his former employer sought to enforce an employment noncompete agreement. In the resulting contract dispute, the court found that the noncompete was supported by adequate consideration, explaining that if the employee

had been discharged shortly after signing the restrictive agreement, this Court would probably hold the agreement was not supported by consideration. But [employee] was not discharged until more than four years had elapsed during which time [employee] had drawn as salary and bonuses about \$200,000. Thus, the actual continuation of

176. See, e.g., *PartyLite Gifts, Inc. v. MacMillan*, 895 F. Supp. 2d 1213, 1221–22 (M.D. Fla. 2012) (finding that employee’s promotion from Consultant to Leader constitutes adequate compensation for an employment noncompete); *Softchoice, Inc. v. Schmidt*, 763 N.W.2d 660, 668 (Minn. Ct. App. 2009) (“[A] promotion serves as consideration for a non-compete agreement . . . when the promotion provides the employee with ‘real advantages.’”).

177. See, e.g., *Digitel Corp. v. Deltacom, Inc.*, 953 F. Supp. 1486, 1496 (M.D. Ala. 1996) (“[C]ontinued employment and compensation in return for a promise not to compete constitutes consideration.”) (quoting *Corson v. Univ. Door Sys., Inc.*, 596 So.2d 565, 568 (Ala. 1991)).

178. See, e.g., *Mail-Well Envelope Co. v. Saley*, 497 P.2d 364, 367 (Or. 1972) (“[I]ncrease [in pay] from \$500 to \$550 per month, plus the payment of commissions by which he was able to so substantially increase his earnings, constituted substantial new and additional consideration so as to make the [employment noncompete] contract . . . legally valid . . .”).

179. See, e.g., *PartyLite Gifts*, 895 F. Supp. 2d at 1223 (M.D. Fla. 2012) (finding that payment of bonuses through the employer’s “Profit Plus Program” constituted consideration for employment noncompete).

180. See, e.g., *Compass Bank v. Hartley*, 430 F. Supp. 2d 973, 979 (D. Ariz. 2006) (“[T]he consideration for the grant of stock options was the promise not to compete . . .”).

181. See, e.g., *Overholt Crop Ins. Serv. Co. v. Bredeson*, 437 N.W.2d 698, 703 (Minn. Ct. App. 1989) (“Economic and professional benefits are sufficient consideration to support subsequent noncompetition agreements.”).

182. 154 So.2d 151 (Miss. 1963).

employment and the receipt by [employee] of these large sums of money as compensation therefor, supplied any lack of consideration.¹⁸³

Implicit in the court's finding that salary and bonuses of \$200,000 supplied consideration for the employment noncompete is a finding that at least part of the salary and bonuses were exchanged for the employment noncompete. Thus, only the remaining part, or some amount less than \$200,000, should therefore be seen as compensation for current labor.

III. CURRENT TAX TREATMENT OF NONCOMPETES

The current tax treatment of a noncompete depends on the context in which the noncompete is acquired. It turns on whether the noncompete is acquired from a business seller as part of a business purchase, from a non-employee, or from an employee. Although the first two contexts are not the subject of this Article, it is useful to consider how tax law treats noncompetes when they are acquired from a business seller or other non-employee because these rules provide a useful contrast to tax law's current treatment of employment noncompetes. This contrast exposes that, while employment noncompetes are the most common and most harmful form of noncompetes,¹⁸⁴ tax law has carelessly allowed them to be treated as inconsistent outliers.

When a noncompete is acquired as part of a business purchase, such as when the seller of a business agrees not to compete with the buyer of that business, the buyer amortizes the value of the noncompete¹⁸⁵ over the fifteen years following the business purchase regardless of the noncompete's term.¹⁸⁶ When a noncompete is acquired by a separate payment to the restrained party not in connection with the purchase of a business, generally it is amortized over the noncompete's term.¹⁸⁷ In both instances, the

183. *Id.* at 154.

184. *See supra* note 31 and accompanying text (estimating that 18%—or nearly one in five—American workers is currently covered by an employment noncompete); *infra* note 189 (explaining why employment noncompetes are most harmful).

185. For simplicity purposes, this sentence has assumed that the business sale was an arm's-length transaction and thus assumes that the cost agreed to for the business sale reflected its value. Because the amortization period for all § 197 intangibles is fifteen years, the aggregate value of all § 197 intangibles is amortized over fifteen years and there is no need to establish separate values for noncompetes or other § 197 intangibles.

186. 26 U.S.C. § 197(a), (d)(1)(E) (2016).

187. *See, e.g.,* *Recovery Grp., Inc. v. Comm'r*, 99 T.C.M. (CCH) 1324, 1327 (2010) (“A covenant not to compete is an intangible asset that, unlike goodwill, does have a limited useful life, defined in the terms of the covenant; and [if it is separately acquired from a non-employee] the cost of obtaining such a covenant is, therefore, amortizable ratably over the life of the covenant . . .”).

noncompete is treated as an intangible asset acquired by the purchaser. In neither instance is it treated as immediately deductible.¹⁸⁸

That forms of noncompetes other than employment noncompetes are capitalized is interesting because they begin wasting immediately and they tend to be less exploitative and less socially harmful than employment noncompetes.¹⁸⁹ This contrast makes it even more surprising that employment noncompetes alone are not capitalized and amortized. Instead, and apparently without much attention, employers immediately deduct the compensation that they pay to their employees in exchange for noncompetes regardless of the noncompete's term and regardless of when that term begins.

A. Employers Quietly, and Without Resistance, Immediately Deduct Payments for Employment Noncompetes

When employers immediately deduct the full amount of compensation they pay to employees who are subject to noncompetes, they take a position in tax law that cannot be reconciled with the position they take in contract law. They claim in tax law that they provide *no* compensation for the noncompete and thus that all compensation they pay is immediately deductible. They claim in contract law that they provide compensation for the noncompete, which forms the consideration necessary to make it a valid and enforceable contract that complies with the reasonableness requirements imposed by most state courts. By admitting that the

188. Note, however, that capitalization is only required if the payment for the covenant not to compete exceeds a \$5,000 de minimis amount and fails the 12-month rule. Payments below a \$5,000 de minimis amount can be immediately deducted. *See, e.g.*, Treas. Reg. § 1.263(a)-4(d)(6)(vii), Ex. 6 (2003) (explaining that party that pays \$100,000 in exchange for three-year covenant not to compete “must capitalize the entire \$100,000 payment” because payment is not de minimis). Similarly, payments for noncompetes that last no longer than twelve months from when they begin and no longer than the end of the year following the year of payment can be immediately deducted according to the “12-month rule” of Treas. Reg. § 1.263(a)-4(f)(1). *See* Treas. Reg. § 1.263(a)-4(l), Ex. 3 (explaining that party that pays \$25,000 to a departing key employee in exchange for a covenant not to compete that begins immediately upon payment and “for a period of 9 months” may be deducted since it satisfies the 12-month rule). If neither the de minimis rule nor the 12-month rule permits immediate deduction, then the noncompete must be amortized over its term according to Treas. Reg. § 1.167(a)-3 (as amended in 2003).

189. *See supra* note 5 (citing cases explaining why employment noncompetes are usually more exploitative than other types of noncompetes).

compensation they pay to their employees is at least partially consideration for their employees being subject to employment noncompete agreements, employers admit that the compensation they pay to their employees is at least partially in exchange for future benefits. Thus, they admit that they should not be allowed to fully immediately deduct all compensation and instead should be required to amortize a portion of compensation over the future period in which they will receive the benefits of the noncompete agreement.

Unfortunately, the IRS has not challenged employers when they violate tax law by fully immediately deducting all compensation they pay to employees subject to noncompete agreements. Indeed, an extensive search for cases or IRS publications in which the IRS argued that a portion of compensation should not be immediately deducted because it compensates for an employment noncompete turned up no authorities. The IRS has not asserted that any portion of compensation should be allocated to a noncompete and amortized over its restricted period, beginning when employment ends. Instead, it has allowed full immediate deduction of compensation paid to employees subject to noncompetes.

It is possible that the IRS's failure to require taxpayers to allocate adequate values to noncompetes is partly an accident grounded in history. Value allocated to a noncompete generally is amortizable, meaning that it is recovered gradually. Currently, a taxpayer prefers to have no value allocated to a noncompete since in the employment noncompete context, the alternative is for all value to be allocated to compensation for current labor and immediately deducted. However, prior to the 1993 passage of § 197, the IRS litigated many business-sale noncompete cases, where the allocation question presented differently. Prior to § 197, taxpayers who purchased businesses had to determine what amount of the aggregate purchase price should be allocated to the seller's noncompete (which would be amortized over the noncompete's term) and what amount should be allocated to goodwill. Taxpayers did not want value allocated to goodwill because value allocated to goodwill was recovered only upon the taxpayer's eventual sale of the business. So instead, they sought to allocate as much value as possible to the noncompete. In response, the IRS routinely argued that less value should be allocated to the noncompete so that more value would be allocated to goodwill. The case law from this period shows the IRS resisting *excessive* allocations of value to noncompetes.¹⁹⁰

190. See, e.g., *Ill. Cereal Mills, Inc. v. Comm'r*, 46 T.C.M. (CCH) 1001, 1021 (1983) (showing IRS's resistance to the allocation of business purchase price to noncompete from former business owner and establishing high burdens of proof to support any such allocation: "[t]o be entitled to amortize a covenant not to compete, a taxpayer must show: (1) that the covenant had independent economic significance such that we might conclude that it was a bargained-for element of the agreement; and (2)

However, the passage of § 197 mooted business-sale noncompete cases by eliminating the need to allocate business purchase prices between noncompetes and goodwill.¹⁹¹ Since then, the question of what value to allocate to a noncompete presents¹⁹² overwhelmingly in employment noncompete cases. In employment noncompete cases, the alternative to amortization is not worse (cost recovery upon resale); rather, it is better (immediate deduction). Thus, predictably, taxpayers do not voluntarily allocate any value to employment noncompetes. Unfortunately, the IRS has not changed its strategy to challenge employers when they allocate *insufficient* value to noncompetes. To the contrary, its rhetoric continues to evidence an unhelpful skepticism that noncompetes can have substantial value or that their value should be treated differently from compensation for current labor.

For example, in the employment noncompete case, *Leste v. Commissioner*,¹⁹³ the IRS attempted to recharacterize payments made “pursuant to a consulting and noncompetition agreement” as additional consideration for the purchase of the consultant’s stock, which would have been capitalized.¹⁹⁴ The IRS lost this recharacterization argument. However, importantly, neither the IRS nor the Tax Court distinguished between payments for current consulting labor and for noncompete restrictions. The court held that the

monthly fee paid to [consultant] constitutes reasonable compensation

that the parties considered the covenant as a valuable part of the entire consideration for the agreement”); *Levinson v. Comm’r*, 45 T.C. 380, 389 (1966) (same); *see also Patterson v. Comm’r*, 49 T.C.M. (CCH) 670 (1985) (prohibiting allocation of value to a noncompete when the business purchase and sale agreement did not include such an allocation).

191. H.R. REP. NO. 102-631, at 210 (1992) (“It is believed that much of the controversy that arises under present law with respect to acquired intangible assets could be eliminated by specifying a single method and period for recovering the cost of most acquired intangible assets and by treating acquired goodwill and going concern value as amortizable intangible assets. . . . Accordingly, the bill requires the cost of most acquired intangible assets, including goodwill and going concern value, to be amortized ratably over a [fifteen]-year period.”).

192. It would be more accurate to say that this issue “should present” overwhelmingly in employment noncompete cases. It does not present in these cases because the IRS does not challenge employers when they allocate no value to a noncompete and immediately deduct all compensation paid to employees subject to noncompetes.

193. 72 T.C.M. (CCH) 1005 (1996).

194. *Id.* at 1006.

for both the consulting services component and the covenant not to compete Consequently, we hold that . . . [employer] is entitled to deduct all of the payments made to [consultant] pursuant to the consulting and noncompetition agreement entered between those parties.¹⁹⁵

Unfortunately, by treating payments for consulting labor and for noncompete restrictions as the same, and both as immediately deductible, the IRS and the Tax Court ignored that noncompete restrictions are primarily associated with future benefits.

It is also possible that the IRS's failure to require taxpayers to allocate adequate value to noncompetes is the result of a simplifying convention run amok. From 2000 until 2002, the Tax Court properly denied several employers' requests to fully, immediately deduct compensation that they paid to employees in the process of obtaining long-term intangible assets, including multiyear loan contracts.¹⁹⁶ Unfortunately, its rulings were reversed on appeal. Instead of continuing to fight for capitalization of the employee compensation costs of acquiring long-term intangibles, the IRS gave up, self-imposed a simplifying convention, and allowed these costs to be deducted. The IRS released an Advance Notice of Proposed Rulemaking suggesting that "to minimize uncertainty and to ease the administrative burden of accounting for transaction costs . . . [,] the rules could allow a deduction for all employee compensation" to obtain long-term intangibles.¹⁹⁷ Reacting to these and similar proposed rules, tax scholars warned that

The Treasury Department seems to have lost its intellectual and moral compass with these proposed regulations. Tax base is squandered by the mile and with ease by the Treasury, but it can be replaced only by inches and with Herculean effort. A strong tax base is an inheritance that needs to be preserved and improved. Only the Treasury

195. *Id.* at 1010. The holding of *Leste* is less problematic than its unqualified language because payments made pursuant to the consulting and noncompete agreement were made monthly and consulting services were provided over the same period as the restricted period. *See also* C.H. Robinson, Inc. v. Comm'r, 76 T.C.M. (CCH) 969 (1998) (holding that amount paid for a covenant not to compete was an immediately deductible business expense); Kalamazoo Oil Co. v. Comm'r, 693 F.2d 618 (6th Cir. 1982) (holding that payments were not an immediately deductible business expense because they were not for a covenant not to compete); Taylor v. Comm'r, 64 T.C.M. (CCH) 1332 (1992) (holding that payments for a covenant not to compete and consulting agreement were deductible by the employer as ordinary and necessary business expenses).

196. *See* PNC Bancorp, Inc. v. Comm'r, 110 T.C. 349 (1998), *rev'd*, 212 F.3d 822 (3d Cir. 2000); Norwest Corp. v. Comm'r, 112 T.C. 89 (1999), *rev'd in part sub nom.* Wells Fargo & Co. v. Comm'r, 224 F.3d 874 (8th Cir. 2000); Lychuk v. Comm'r, 116 T.C. 374 (2001).

197. *Blasius v. Comm'r*, 90 T.C.M. (CCH) 274, 277 (2005) (alterations in original) (quoting Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461, 3464 (proposed Jan. 24, 2002)).

Department can protect our tax base. The secular, even sacred duty of the Treasury Department is to defend and strengthen the tax base against those who every day would destroy it, and these regulations are a breach of that duty.¹⁹⁸

Unfortunately, even though the simplifying convention allowing immediate deduction of employee compensation paid to acquire long-term intangibles would destroy significant tax base, causing less tax revenue to be collected, the IRS began following this simplifying convention even before it was finalized as part of the so-called *INDOPCO* regulations,¹⁹⁹ discussed in Section III.B, below. “On March 15, 2002, [the IRS] issued Chief Counsel Notice (CCN) 2002-21, in which the Chief Counsel announced that the IRS would no longer ‘assert capitalization under section 263(a) for employee compensation . . . related to the acquisition, creation, or enhancement of intangible assets or benefits.’”²⁰⁰

Since this simplifying convention was effectively self-imposed by the IRS after cases involving multiyear loan contracts, it seems reasonable to assume that the IRS intended for it to apply to intangible assets that begin wasting immediately. However, it is now being used in a way that likely was not intended. When employers deduct the compensation they pay to acquire an employment noncompete, they deduct a cost that *does not even begin* wasting until years after payment, when the employment relationship ends, and the restricted period begins.

Whether the IRS’s lack of resistance to an employer’s full, immediate deduction of employee compensation paid to acquire an employment noncompete is grounded in a historical accident or a simplifying convention run amok, the critical point is that the IRS has not resisted. Since employers prefer to immediately deduct all compensation they pay to employees subject to noncompetes and since the IRS has not challenged this full

198. Calvin Johnson, *Destroying Tax Base: The Proposed INDOPCO Capitalization Regulations*, 99 TAX NOTES 1381, 1382 (2003).

199. *Blasius*, 90 T.C.M. (CCH) at 277 (observing that the Chief Counsel Notice of March 15, 2002 predated by several months Treasury’s December 19, 2002 issuance of proposed regulations under section 263(a) [the *INDOPCO* regulations] that “also permit a deduction in the year incurred for all ‘compensation paid to employees (including bonuses and commissions paid to employees)’” to “create or enhance an intangible asset”).

200. *Id.*

immediate deduction, it is not surprising that case law is sparse on the tax treatment of employment noncompetes. Our adversarial system is not good at exposing errors when neither party to a dispute raises the issue. Interestingly, however, one of the rare statements about the tax treatment of employment noncompetes shows how quietly this error has been allowed to lie.

In the Tax Court Memorandum opinion, *Winter v. Commissioner*,²⁰¹ Tax Court Judge Holmes hinted that the IRS might not be properly addressing the tax treatment of employment noncompetes. And then quickly dropped the issue. All in a footnote.²⁰²

The facts of *Winter* are more complicated than a straight-forward employment noncompete in which an employer pays compensation to an employee subject to a noncompete and immediately deducts it in full, effectively ignoring the future benefit that the noncompete will produce. Instead, the case primarily depended on other potential future benefits and other potential timing questions.

In *Winter*, a bank employee received a \$5.1 million prepayment of a five-year bonus in 2002. The employee (*Winter*), the employer (the bank), and the IRS all agreed that \$1.1 million of the bonus was earned in 2002, and \$4 million was a prepayment of amounts expected to be earned from 2003 through 2006.²⁰³ Thus, at the time of the prepayment, \$1.1 million was immediately deductible and \$4 million was amortizable over the period benefitted, from 2003 through 2006. However, things did not go as planned. Before the close of the 2002 tax year, the bank fired the employee and demanded that he return the \$4 million prepayment portion of the bonus.²⁰⁴ He refused and invoked a provision in his employment contract that converted prepaid bonuses into severance payments in the event of firing.²⁰⁵

As to the tax treatment of the \$4 million, the court applied tax law's contested liability rules to conclude that the employer could immediately deduct the \$4 million because, prior to the close of the 2002 tax year, it had been converted from an amortizable bonus prepayment into an immediately deductible severance payment.²⁰⁶ Thus, the employer could deduct the full \$5.1 million in 2002, including a \$1.1 million earned bonus and a \$4 million earned severance payment.

201. 100 T.C.M. (CCH) 604 (2010).

202. *Id.* at 609 n.11.

203. *Id.* The implication is that the bonus was \$5.5 million for five years, or \$1.1 million per year. However, \$5.1 million was prepaid to reflect a discounted present value of the \$5.5 million over five years. *Id.*

204. *Id.*

205. *Id.*

206. *Id.*

What is most interesting about *Winter* is what happens in footnote 11. In footnote 11, the Tax Court *sua sponte* raises an issue that is central to the thesis of this Article. It states,

It's possible that the employment agreement would benefit [the employer] beyond 2002 via two restrictive covenants [. . . including²⁰⁷] a one-year covenant not to compete following Winter's termination. But it's not clear from the contract what portion, if any, of Winter's compensation was in consideration for these covenants, or if the covenants offer more than an incidental benefit.²⁰⁸

Unfortunately, the Tax Court was alone in spotting the critical issue that the \$5.1 million compensation was still associated with a future benefit (even after it ceased to be a prepaid bonus) because it compensated for a noncompete that extended beyond 2002.

Had the IRS raised this issue, the Tax Court could have found that the portion of compensation allocable to the noncompete was nondeductible and, instead, was amortizable over the restricted period. Instead, the IRS failed to allocate any value to the noncompete and failed to invoke burden of proof rules that would have required the taxpayer to propose and support such an allocation. Thus, the IRS presented the Tax Court with an incomplete factual record.

Winter's footnote 11 states the problem plainly.

Both parties [the IRS and the taxpayer] implicitly value [the future benefits associated with the employment noncompete] at zero. The Commissioner argues that [the employer] properly deducted the first \$1.1 million in 2002 because Winter had provided one-fifth of the total services—this can only be true if none of the \$5.5 million is allocated to the covenants. Winter also ignores the covenants by arguing that the full payment should be deducted in 2002 as part compensation and part severance. [The failure to allocate any value to the noncompete] isn't a jurisdictional argument, so we won't make

207. The second covenant was a confidentiality and loyalty clause not relevant to this argument.

208. *Id.* at 609 n.11 (citations omitted).

an argument for the parties that they do not make for themselves.²⁰⁹

When the IRS fails to assert that an employment noncompete provides benefits that an employer will receive in future years (from when the employment relationship ends until the restricted period ends), require an adequate allocation of value to those future benefits, or otherwise challenge an employer when it immediately deducts the full compensation it pays to an employee subject to a noncompete, it prevents courts from properly enforcing tax law. It enables employment noncompetes to thrive. Worse, it means that employment noncompetes receive an unfairly preferential—and unexamined—tax benefit. To put it bluntly, the IRS subsidizes harmful restrictions on the employment mobility and opportunities of thirty million American workers.

B. *Violates Expense vs. Expenditure*

When employers immediately deduct the full compensation they pay to employees subject to noncompetes, they violate tax law. Most importantly, they violate tax law's fundamental distinction between trade or business expenses, which are fully and immediately deductible,²¹⁰ and prepayments or other expenditures,²¹¹ which are not. When applied to compensation, this distinction means that employers can immediately deduct the compensation they pay to their employees when it is an expense that compensates for labor that produces benefits enjoyed entirely within the year of payment.²¹² However, they cannot immediately deduct the compensation they pay to their employees when it is a prepayment or other expenditure that produces significant benefits beyond the year of payment.²¹³

The United States Supreme Court required an employer to capitalize employee compensation that produced long-term benefits in *Commissioner v. Idaho Power Co.*²¹⁴ The Court ruled that compensation cannot be

209. *Id.*

210. 26 U.S.C. § 162 (2017).

211. SAMUEL A. DONALDSON & DONALD B. TOBIN, FEDERAL INCOME TAX: A CONTEMPORARY APPROACH 209 (2d ed. 2012). While the term “expenses” is not defined in Section 162, other Code provisions (including Sections 263A and 263a establishing that certain outlays are expenditures rather than expenses) and extensive case law establishes that expenses are outlays other than expenditures and that expenditures “are those costs that provide a long-term benefit to the taxpayer.” *Id.*

212. *See, e.g.*, 26 U.S.C. § 162(a)(1) (2017) (specifically authorizing immediate deduction for “a reasonable allowance for salaries or other compensation for personal services actually rendered”).

213. DONALDSON & TOBIN, *supra* note 211, at 212 (“[O]nly expenses are deductible under 162 . . . Expenses are distinct from capital expenditures. The latter create or add to basis and cannot be deducted in the year paid or incurred. In some cases, capital expenditures are deducted over time in the form of deductions for depreciation and amortization . . . In other cases, capital expenditures are recovered only when the taxpayer disposes of the particular asset created or improved by the capital expenditure.”).

214. 418 U.S. 1 (1974).

deducted, and instead must be capitalized, when it is paid to employees to construct a building that will benefit the employer beyond the year of payment.²¹⁵ As the Court explained, “when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized [or depreciated] over the life of the capital asset so acquired.”²¹⁶

The Court reasoned that, when a taxpayer pays compensation to acquire a lasting asset, the payment is not expended; rather, it is “assimilated into the cost of the capital asset constructed.”²¹⁷ While *Idaho Power* involved compensation paid to acquire a tangible capital asset, its reasoning applies similarly when compensation is paid to acquire an intangible asset.²¹⁸

The Supreme Court has not just required capitalization of compensation paid to acquire lasting tangible and intangible assets,²¹⁹ it has required capitalization of compensation paid to acquire lasting intangible benefits. In *INDOPCO, Inc. v. Commissioner*,²²⁰ the taxpayer faced the prospect of a

215. *Id.* at 19. The holding of *Idaho Power* has since been codified in 26 U.S.C. § 263A, otherwise known as the Uniform Capitalization Rules.

216. *Idaho Power*, 418 U.S. at 13 (citing *Briarcliff Candy Corp. v. Comm’r*, 475 F.2d 775, 781 (2d Cir. 1973); *Perlmutter v. Comm’r*, 44 T.C. 382, 404 (1965), *aff’d*, 373 F.2d 45 (10th Cir. 1967); *Jaffa v. United States*, 198 F. Supp. 234, 236 (N.D. Ohio 1961); *Treas. Reg.* § 1.266-1(e)).

217. *Idaho Power*, 418 U.S. at 14.

218. *See, e.g.*, *FMR Corp. v. Comm’r*, 110 T.C. 402, 417 (1998) (requiring capitalization of compensation paid in the process of creating regulated investment companies); *Lychuk v. Comm’r*, 116 T.C. 374, 398 (2001) (requiring capitalization of compensation paid in the process of evaluating and acquiring multi-year installment contracts). *But see supra* note 196 and accompanying text for negative subsequent treatment of these cases.

219. The case to capitalize and amortize the value of a noncompete over its restricted period is strong because a noncompete *is* a separate and distinct intangible asset with a determinable useful life. *See Recovery Grp., Inc. v. Comm’r*, 99 T.C.M. (CCH) 1324, 1327 (2010) (“A covenant not to compete is an intangible asset that . . . [has] a limited useful life, defined in the terms of the covenant.”). *But see Johnson, supra* note 198, at 1383 (arguing that difference between separate and distinct intangible *assets* and lasting intangible *benefits* is immaterial because, for accounting purposes, basis is an asset, so an asset may be created on a business’s accounting books for the purpose of tracking basis); *Treas. Reg.* § 1.263(a)-4(b)(3) (establishing current requirement that a separate and distinct intangible asset be “subject to protection under . . . law” and “intrinsicly capable of being sold, transferred or pledged . . . separate and apart from a trade or business”).

220. 503 U.S. 79 (1992). *See also Metrocorp, Inc. v. Comm’r*, 116 T.C. 211, 221–22 (2001) (“When an expense does not create [a separate and distinct] asset, the most critical factors to consider in passing on the question of deductibility are the period of time over which the taxpayer will derive a benefit from the [outlay] and the significance to the taxpayer of that benefit. [Outlays] must generally be capitalized when they . . . generate significant benefits for the taxpayer extending beyond the end of the taxable year.”) (citations omitted).

friendly takeover by one of its main customers.²²¹ Before the takeover was approved, it had to ensure that its shareholders received a fair price for their shares.²²² To fulfill its fiduciary duty to its shareholders, it paid \$2.2 million to an investment firm “to evaluate its shares, [and] to render a fairness opinion”²²³ and \$490,000 to a law firm to advise it on the tax consequences of the takeover.²²⁴ Then, it sought to immediately deduct these payments.²²⁵

The taxpayer in *INDOPCO* argued that the compensation it paid to its investment and legal advisors ought to be deductible because it was for services rendered within the year of payment. However, the Court required that the compensation be capitalized since it was for services provided in connection with a takeover that would benefit the taxpayer for many years. As the Court explained, a cost “that ‘is of value in more than one taxable year’ is a nondeductible capital expenditure”²²⁶ while a cost that is of value primarily²²⁷ within the tax year is an immediately deductible expense.²²⁸

As the unanimous opinion explained, the “predominant” factor determining whether an outlay is an immediately deductible expense or a capital expenditure is “the duration and extent of the benefits realized by the taxpayer.”²²⁹ As one scholar put it, “the broader implication of the *INDOPCO* decision was that taxpayers must capitalize expenditures made for the ‘betterment’ of . . . their business over a period of time ‘somewhat longer than the current taxable year.’”²³⁰ This is true even when the expenditure is compensation.

The distinction between immediately deductible expenses and expenditures (which are “capitalized” meaning added to basis and recovered upon disposition of the asset or gradually over time through amortization or

221. *INDOPCO*, 503 U.S. at 80.

222. *Id.* at 81.

223. *Id.*

224. *Id.* at 81–82.

225. *Id.* at 82. (“National Starch claimed a deduction for the \$2,225,586 paid to Morgan Stanley” and later asserted “the right to deduct . . . legal and miscellaneous expenses” on its year-of-merger tax return).

226. *Id.* at 87 (citing *United States v. Miss. Chem. Corp.*, 405 U.S. 298, 310 (1972)).

227. *See id.* (noting that “the mere presence of an incidental future benefit” does not require capitalization).

228. *Id.*

229. *Id.* at 88.

230. Daniel J. Hemel, *The President’s Power to Tax*, 102 *CORNELL L. REV.* 633, 691 (2017).

depreciation deductions)²³¹ is fundamental to tax law.²³² This distinction is maintained so that tax is imposed on net income. If a cost is fully expended within the year it is paid, then it is properly viewed as a cost of earning that year's income and should be fully deducted against that year's income.²³³ In contrast, if a cost is not fully expended within the year it is paid, and instead retains value into future years, then it is properly viewed as a cost of earning income over many years. A portion of the cost should be deducted in each of the years benefitted so that, after accounting for these deductions, tax is imposed on net income. "The matching of a current year's [outlays] that benefit future years with such future years' income (by capitalization and basis recovery) is necessary in order to prevent distortion of income"²³⁴

231. DONALDSON & TOBIN, *supra* note 211, at 210 ("[W]hile taxpayers may be able to deduct various *expenses* paid or incurred during a taxable year, taxpayers generally cannot deduct capital expenditures. Instead, capital expenditures add to (or create) taxpayer's basis in property . . . If a taxpayer must capitalize a cost, the taxpayer can recover that cost ultimately upon the sale or disposition of the underlying asset. . . . In many cases, however, taxpayers do not have to wait until disposition of an asset to recover the cost of a capital expenditure. Instead, the cost can be recovered over a period of years roughly equivalent to the useful life of the underlying asset. . . . With respect to intangible property, the applicable cost recovery system is called amortization.").

232. See, e.g., Calvin H. Johnson, *The Expenditures Incurred by the Target Corporation in an Acquisitive Reorganization Are Dividends to the Shareholders: (Pssst, Don't Tell the Supreme Court)*, 53 TAX NOTES 463, 478 (1991) ("A strong law of capitalization is extraordinarily important to an income tax. Under the norms of an income tax, costs that constitute investments, generating future income for the taxpayer, are capitalized and may not be deducted so long as the costs continue to generate income."); Lily Kahng, *Who Owns Human Capital?*, 94 WASH. U. L. REV. 607, 624 (2017) ("Under the principle of capitalization, the foundational importance of which the Supreme Court has affirmed in its jurisprudence, capital owners ought to capitalize expenditures they incur to acquire or create intellectual capital.") (footnotes omitted); *id.* at 625 ("The idea that businesses should capitalize expenditures that produce future benefits is integral to the concept of income, and tax law has required capitalization since its inception.") (footnotes omitted).

233. Thus, the Code allows immediate deduction of supplies (typically tangible assets with a useful life of one year or less) and of intangible assets that satisfy the twelve-month simplifying convention. Treas. Reg. § 1.162-3(a)-(c) (treating tangible assets with a useful life of one year or less as deductible supplies); Treas. Reg. § 1.263(a)-4(f) (treating intangible assets that satisfy the twelve-month simplifying convention as deductible). The twelve-month simplifying convention is not a faithful application of this principle since it allows immediate deduction of costs of intangibles that have benefit in the year *following* the year of payment.

234. John W. Lee, *Transaction Costs Relating to Acquisition or Enhancement of Intangible Property: A Populist, Political, but Practical Perspective*, 22 VA. TAX REV. 273, 316 (2002); see also *id.* at 317-18 (describing the matching principle as theoretically correct and proposing certain times when "this theoretically correct matching should yield either to a current deduction or amortization over some safe harbor period to produce minimal distortion of income.").

When expenditures that provide future benefits are treated as expenses and immediately deducted, the mismatch causes significant economic problems. As Calvin Johnson explains,

When tax law violates the prime directive [that costs should be capitalized and recovered such that the remaining basis equals the remaining income-producing value of the investment], several terrible things happen. First, tax-rate neutrality is violated: Either high-bracket taxpayers outbid lower-bracket taxpayers for the same goods and investments or high-bracket taxpayers achieve an effective tax rate lower than the statutory tax rate that Congress has mandated. Second, [allowing tax deductions to outpace the actual economic decline in an asset's value] means that investors move out of meritorious [slower-recovered] investments and into worse [quicker-recovered] investment, just to take advantage of the tax benefit of low basis. Thirdly, adjusted basis below value means that debt financing of these investments produce artificial losses and negative taxes. The negative taxes shelter unrelated income from tax. Both tangible and intangible investments need to follow the same rules, whatever they are, just so that the shelter value of expensed intangibles will not lead to inferior investments appearing to be better.²³⁵

If the distinction between expenses and expenditures was properly applied to employment noncompetes, noncompetes would be deemed expenditures. Employers do not benefit from them immediately, within the year in which they are acquired. Rather, employers begin benefiting from them after the employment relationship ends, and then gradually over the restricted period. Accordingly, any payments for employment noncompetes—whether or not in the form of compensation—should not be immediately deductible and instead should be capitalized and amortized over the restricted period.

Despite its consistency with fundamental tax principles, the business community vehemently opposed *INDOPCO*. A lobbying group known as the “*INDOPCO* Coalition” formed to advocate for regulations that would narrow the ruling.²³⁶ It was successful.²³⁷ In 2004, Treasury issued final regulations “that significantly weakened the *INDOPCO* decision,”²³⁸ by

235. Johnson, *supra* note 198, at 1383.

236. DONALDSON & TOBIN, *supra* note 211, at 244. *See also* Blasius v. Comm’r, 90 T.C.M. (CCH) 274, 280 (2005) (referencing “years of intensive, and ultimately successful, lobbying by the likes of the *INDOPCO* Coalition to impress its views on the IRS”).

237. *See, e.g.*, Hemel, *supra* note 230, at 689 (arguing that the regulations “commonly known as the ‘*INDOPCO* regulations’” might better be termed the “‘anti-*INDOPCO* regulations’ because they effectively overturn the Supreme Court’s decision in *INDOPCO, Inc. v. Commissioner*”); *id.* at 691 (“In several respects, the regulations deviated from the *INDOPCO* decision in a ‘taxpayer-favorable’ direction.”) (citing Ethan Yale, *The Final INDOPCO Regulations*, 105 TAX NOTES 435, 435–36 (2004)).

238. DONALDSON & TOBIN, *supra* note 211, at 244.

reversing the default rule of capitalization for compensation payments that create long-term intangible assets and making deductibility the norm for created intangibles.²³⁹ These regulations also included several simplifying conventions to permit taxpayers to fully and immediately deduct costs that produce long-term benefits. Legal scholars critique the *INDOPCO* regulations as being an inappropriate use of Treasury's power, especially because they undermined a decision by the United States Supreme Court.²⁴⁰ They have further critiqued the simplifying conventions for inappropriately forfeiting billions of dollars in tax revenue for insufficient benefit.²⁴¹ Although the *INDOPCO* regulations do not clearly allow employers to immediately deduct the amounts they pay for employment noncompetes, they are ambiguous. Accordingly, in Part IV, this Article proposes changes to two of the *INDOPCO* regulations to clarify that payments for employment noncompetes should be capitalized.

C. Violates Burden of Proof Rules

In addition to getting right that outlays should be capitalized when they create benefits lasting beyond the tax year and deducted only when they create benefits that are exhausted within the tax year, *INDOPCO* got right the critically important matter of the burden of proof. Proper placement of the burden of proof is important in these cases because, as the Court noted, “the ‘decisive distinctions’ between current expenses and capital

239. James L. Atkinson, *The Final INDOPCO Regulations: A Primer*, 56 TAX EXECUTIVE 222, 224 (2004).

240. See, e.g., Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 243 (2004) (“When faced with a Supreme Court interpretation of an ambiguous statutory term in the Code that it wants changed, the Treasury has . . . [only one valid option, which is to] propose legislation to Congress to amend the underlying statute.”); *id.* at 243–44 (“Treasury has shown a recent tendency to choose [another] solution—attempting to change the interpretation in a taxpayer-friendly manner. . . . [An] example is the Treasury’s . . . promulgation of regulations regarding the important issue of whether an expense can be immediately deducted or must be capitalized. . . . [T]hese regulations are generally taxpayer-friendly (although not in every single case) and have been extensively praised by private practitioners. . . . [However,] these regulations are also inconsistent with a Supreme Court decision, *INDOPCO v. Commissioner*, that is directly on point. Accordingly, these regulations are invalid to the extent they are inconsistent with *INDOPCO*.”) (footnotes omitted).

241. See, e.g., Johnson, *supra* note 198, at 1394.

expenditures ‘are those of degree and not of kind,’” with each case turning on “its special facts.”²⁴² Burden matters for close calls.

In *INDOPCO*, the Court properly put the burden of proof on the taxpayer who sought to immediately deduct the compensation it paid for investment and legal services. After finding that the taxpayer “has not demonstrated that the investment banking, legal, and other costs it incurred . . . are deductible as ordinary and necessary expenses,” the Court required capitalization of these outlays.²⁴³ As the Court explained, “In exploring the relationship between deductions and capital expenditures, this Court has noted the ‘familiar rule’ that ‘an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.’”²⁴⁴ All outlays are assumed to be expenditures. Thus, the default treatment of capitalization is avoided only when a taxpayer satisfies a “strictly construed”²⁴⁵ exception and establishes that the outlay does not produce significant future benefits.

If tax law’s burden of proof rules were properly applied to employment noncompetes, then all payments for noncompetes would be capitalized. If these payments were aggregated with other payments—like compensation payments for current labor—then the aggregate payment should be capitalized except to the extent that the payor meets its burden to establish the deductible portion.

D. Subsidizes that Which We Oppose

By allowing employers to immediately deduct the full amounts they pay employees for becoming subject to noncompetes, the government provides a significant subsidy (one very much like the subsidy that section 401(k) gives to traditional retirement accounts) for noncompetes. This subsidy is shocking in light of the government’s clearly expressed—and justified—opposition to employment noncompete agreements.

242. *INDOPCO v. Comm’r*, 503 U.S. 79, 86 (1992) (quoting *Welch v. Helvering*, 290 U.S. 111, 114 (1933) and *Deputy v. Du Pont*, 308 U.S. 488, 496 (1940)).

243. *Id.* at 88.

244. *Id.* at 84 (quoting *Interstate Transit Lines v. Comm’r*, 319 U.S. 590, 593 (1943)). *See also* *Fred W. Amend Co. v. Comm’r*, 454 F.2d 399, 402 (7th Cir. 1971) (“[D]eductions [including section 162 deductions for trade or business expenses] are a matter of legislative grace, and unless the claimed deduction comes clearly within the scope of the statute it is not to be allowed. The burden to make that showing rests upon the taxpayer.”) (citation omitted). *But see* *Lohr v. Comm’r*, 35 T.C.M. (CCH) 1382, 1384 (1976) (“[A] certain, limited class of deductions may be required to insure that the tax is imposed only upon ‘income [as required by the Sixteenth Amendment].’”) (citing Note, *Taxability of Gross Income Under the Sixteenth Amendment*, 36 COLUM. L. REV. 274 (1936)); *Davis v. United States*, 87 F.2d 323 (2d Cir. 1937), *cert. denied* 301 U.S. 704 (1937) (speculating that certain deductions are required to ensure that the tax is imposed on income and not capital).

245. *INDOPCO*, 503 U.S. at 84.

First, it is useful to understand that the current subsidy for employment noncompetes is massive. This subsidy comes in the form of a full, immediate deduction provided to an employer for the cost of acquiring a noncompete agreement from its employee. As tax scholars have long recognized, when an immediate deduction is provided for an investment that produces long-term value, the result is equivalent to exempting returns on that investment from tax.²⁴⁶ The most accessible example of this yield-exemption phenomenon is retirement accounts. Distributions from Roth retirement accounts are tax-exempt. By contrast, distributions from traditional retirement accounts are taxable. Nevertheless, assuming that the same tax rate applies to contributions to and distributions from retirement accounts, traditional retirement accounts are equivalent to Roth retirement accounts because the ability to fully and immediately deduct amounts invested in traditional accounts is as valuable as the ability to exempt returns from Roth accounts. The immediate deduction of contributions means that traditional retirement holders can afford to make larger investments and the returns on these larger investments are sufficient to cover their future tax bills.

Unfortunately, the current payments that employers make to employees in exchange for noncompetes are like contributions to traditional retirement accounts in that they are fully and immediately deducted, produce long-term returns on investment, and give rise to future taxes on returns that can be

246. This “yield-exemption” phenomenon depends on certain assumptions, including that the initial deduction is taken at the same tax rate as applies to all future returns on the investment. The yield-exemption phenomenon was first explained by MIT economist E. Cary Brown. See, e.g., Rebecca Morrow, *Government as Investor: The Case of Immediate Expensing*, 106 KY. L.J. 1, 8 (2017) (“In short, [the yield-exemption phenomenon] observes that a taxpayer who immediately expenses an asset receives an extraordinary benefit from the government at the time of investment in the form of tax savings equal to the cost of the investment times the taxpayer’s marginal tax rate. These tax savings mimic a capital contribution. If they are used to fund part of the investment’s purchase price, then the outcome is analogous to the government putting up capital equal to the tax savings and the purchaser putting up the remaining capital. When the government then . . . collects a proportionate share of profits from the investment (by taxing them), the imposition of tax is analogous to the government taking a proportionate return on its up-front capital contribution.”); Johnson, *Expenditures Incurred by the Target Corporation*, *supra* note 232, at 478 (“The thesis that expensing an investment, that is, deducting it immediately, is equivalent to exempting the subsequent income from the investment from tax, is one of the bulwarks of modern tax economics, but it is not generally known or appreciated within the tax law community.”).

paid for with the tax savings from the initial deduction plus the returns on those initial tax savings.

This subsidy is not unique to employment noncompetes. Tax scholars have long recognized instances in which tax law allows the full, immediate deduction of investments that produce long-term benefits. For example, the *INDOPCO* regulations²⁴⁷ allow employers to fully immediately deduct employee compensation even when it is paid to create an intangible with long-term value. However, in the case of employment noncompetes, this subsidy is worse.

Professor Calvin Johnson rightly opposes the many features of the *INDOPCO* regulations that allow for the full and immediate deduction of costs that produce long-term value.²⁴⁸ He argues that the *INDOPCO* regulations are wrong-headed in presenting these features as simplifying conventions or *de minimis* exceptions that are justified by considerations such as administrability and ease of compliance. On the contrary, he suggests, they are dangerous violations of tax law's critical capitalization rules that result in hundreds of billions of dollars of lost tax revenue and a dangerous misallocation of resources toward long-term investments that can be deducted. Thus, Johnson argues that taxpayers should not be allowed to immediately deduct, and instead should be required to capitalize, their investments in intellectual capital, "businesses' investment in and production of intangible sources of future value, which often require a high proportion of labor inputs."²⁴⁹

Professor Lily Kahng agrees and observes that the full, immediate deduction of employer investments in long-term intangibles produced by their employees²⁵⁰ is increasingly problematic as the value of intangibles surges and becomes an ever-greater driver of firm value and economic growth.²⁵¹ While rules allowing full, immediate deduction of investments in

247. Particularly, Treas. Reg. § 1.263(a)-4 (as amended in 2004).

248. See Calvin H. Johnson, *First Do No Harm: The Senate Staff Discussion Draft on Cost Recovery*, 142 TAX NOTES 549, 550–51 (2014); Calvin H. Johnson, *Extend the Tax Life for Acquired Intangibles to 75 Years*, 135 TAX NOTES 1053, 1053–56 (2012); Calvin H. Johnson, *Capitalize Costs of Software Development*, 124 TAX NOTES 603 (2009); Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 TAX NOTES 1289 (2008); Calvin H. Johnson, *Capitalization After the Government's Big Win in INDOPCO*, 63 TAX NOTES 1323 (1994); Johnson, *supra* note 198, at 478.

249. Kahng, *Who Owns Human Capital?*, *supra* note 232, at 610 n.10; Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 TAX NOTES 1289, 1289 (2008) (calling for "fixing the problem of intangibles by aggressively capitalizing intangible investments.").

250. Kahng, *Who Owns Human Capital?*, *supra* note 232, at 629 ("The *INDOPCO* regulations set forth an exclusive list of eight relatively narrow types of intangible assets whose development or creation costs businesses must capitalize. Even though other self-created intangibles in theory might be subject to capitalization, in practice, the *INDOPCO* regulations permit taxpayers to deduct all other self-created intangibles 'without hesitation.'") (footnotes omitted) (quoting Ethan Yale, *The Final INDOPCO Regulations*, 105 TAX NOTES 435, 437 (2004)).

251. *Id.* at 613 ("Economists estimate that official measures of gross domestic product in recent years omitted as much as one trillion dollars per year of investments in intellectual capital."); *id.*

long-term intangibles are presented as mere simplifying conventions or *de minimis* exceptions, Kahng cautions that tax law's current improper allowance of "deductions for most investments in intellectual capital[] is fundamentally flawed . . . [and] results in the loss of hundreds of billions of dollars in tax revenues, costly misallocations of resources, and a grave deviation from the accurate measure of income."²⁵²

As Kahng explains in an application of the yield-exemption phenomenon, "the deduction for self-created intellectual capital effectively imposes a zero rate of tax on returns from this capital."²⁵³ Because tax law only allows full, immediate deduction of investments in self-created intangibles and requires capitalization and amortization of investments in acquired intangibles, tax law encourages businesses to misallocate resources by buying too few intangibles from third parties and acquiring too many intangibles from its own workers. Further, it incentivizes employers to increase the damaging trend of turning the fruit of their employees' knowledge and skills into a commodity owned by the employer and severed from attachment to the employee. "In sum," concludes Kahng, "the tax law, by allowing capital owners to deduct the costs of self-created intellectual capital, subsidizes the propertization of labor and enhances capital owners' ability to appropriate a greater share of the return [on labor] at the expense of their workers' share."²⁵⁴

Kahng advocates a reversal of the *INDOPCO* regulations so that employers would be required to capitalize the costs of creating intellectual capital.²⁵⁵ This proposal would reflect a return to *INDOPCO*'s rule that compensation is not deductible to the extent that it is a cost of producing long-term benefits.

One might view an employment noncompete as just another type of intangible asset obtained by an employer from an employee, or what Calvin

("Google and Microsoft's self-created intangible assets are worth hundreds of billions of dollars, as evidenced by their market capitalization . . ."); *id.* at 614 ("[I]ntellectual capital accounted for 27 percent of economic growth, putting it on par with tangible capital in importance as a source of economic growth.").

252. Lily Kahng, *The Taxation of Intellectual Capital*, 66 FLA. L. REV. 2229, 2229 (2014).

253. Kahng, *Who Owns Human Capital?*, *supra* note 232, at 631.

254. *Id.* at 639.

255. *Id.* at 648.

Johnson describes as “intangible investments”²⁵⁶ or Lily Kahng describes as “intellectual capital”²⁵⁷ or “human capital.”²⁵⁸ These categories of intangibles have been described as “dark matter” because their definitions are elusive and fluid.²⁵⁹ Putting aside definitional concerns for a moment, however, one might view an employment noncompete simply as another intangible asset falling in one or more of these categories. An employer pays compensation to an employee in exchange for a noncompete just as it pays compensation to an employee in exchange for a strategic plan, or for a marketing idea, or for increasing brand recognition or goodwill. These investments produce long-term benefit, and so, as Johnson, Kahng and others²⁶⁰ advocate, a portion of the compensation paid to employees should be allocated to the associated future benefits and that portion of compensation should be capitalized rather than immediately deducted. Treating employment noncompetes as just another type of intangible asset—either created by or acquired from an employee and requiring their capitalization—would be an improvement. However, this view does not go far enough.

Employment noncompetes are not like other intangible assets obtained by employers from their employees. Their differences—and the magnitude of their importance—justify a unique tax treatment.

First, employment noncompetes are unlike other intangible assets obtained by employers from employees in that they trigger *delayed* benefits as opposed to long-term benefits. Generally, the intangibles that employers receive from their employees—things like strategic planning, marketing, brand recognition, and goodwill—produce economic benefits immediately upon acquisition. They should be capitalized because their economic

256. Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 TAX NOTES 1289, 1291 (2008).

257. See *supra* note 249 and accompanying text; Kahng, *Who Owns Human Capital?*, *supra* note 232, at 610, n.10; Kahng, *The Taxation of Intellectual Capital*, *supra* note 252, at 2235 (defining intellectual capital as “sources of probable future economic profits, lacking physical substance, which are controlled by a firm as a result of previous events or transactions”) (emphasis omitted).

258. Kahng, *Who Owns Human Capital?*, *supra* note 232, at 610, n.10.

259. Charlene D. Luke, *Illuminating the Dark Matter of Intellectual Capital*, 66 FLA. L. REV. F. 61, 61 n.1 (2015) (quoting Lily Kahng, *The Taxation of Intellectual Capital*, 66 FLA. L. REV. 2229, 2231 (2014)); Ricardo Hausmann & Federico Sturzenegger, ‘Dark Matter’ Makes the U.S. Deficit Disappear, FIN. TIMES (Dec. 8, 2005), <https://www.ft.com/content/efc48142-6753-11da-a650-0000779e2340> (“‘[D]ark matter’ . . . corresponds to assets that generate revenue but cannot be seen.”); Kahng, *Who Owns Human Capital?*, *supra* note 232, at 612 n.16 (“Despite the difficulty of precisely defining intellectual capital, the concept is easy to grasp intuitively, and its many definitions share core similarities.”).

260. See, e.g., David A. Weisbach, *Measurement and Tax Depreciation Policy: The Case of Short-Term Intangibles*, 33 J. LEGAL STUD. 199 (2004); Ethan Yale, *The Final INDOPCO Regulations*, 105 TAX NOTES 435 (2004); John Lee, Eldridge Blanton, Veena Luthra, Glenn Walberg, & Darryl Whitesell, *Restating Capitalization Standards and Rules: The Case for Rough Justice Regulations (Part One)*, 23 OHIO N.U. L. REV. 631 (1997); George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179 (1987).

benefits last beyond a tax year. But these intangibles begin wasting immediately and are often most valuable in the year of acquisition and less valuable in subsequent years.²⁶¹

The common feature of employment noncompetes is that they do not even begin wasting—indeed, they do not begin binding—until the employment relationship terminates.²⁶² It is possible that they provide some ancillary benefit before the employment relationship terminates if, for example, they cause a valuable employee to stay longer than she would in the absence of a noncompete. However, the primary benefit begins when the employment relationship ends. Thus, employment noncompetes should be amortized over a different recovery period from other intangible assets obtained by employers from employees. Amortization of employment noncompetes generally should not even begin until the employment relationship terminates.²⁶³

Second, employment noncompetes are unlike other intangible assets obtained by employers from employees in that their useful lives are easily determinable. Noncompetes bind, and have value to an employer, over a specified period. This makes them unlike strategic planning, marketing, brand recognition, goodwill, and similar intangibles whose useful lives are amorphous and can only be roughly approximated. Since the value that an employer receives from an employment noncompete is gradually spent over the restricted period, amortization ought to occur ratably over that restricted period.

Finally, employment noncompetes should not be treated as though they produce the types of positive externalities produced by other created intangibles. Employer investments in strategic planning, marketing, brand recognition, goodwill, and similar intangibles generally are pro-competitive and produce benefits for employees and the public. In contrast, and as was

261. Advertising, for example, includes significant immediate and short-term benefits and diminishing, trailing longer-term benefits. *See, e.g.*, Carol Corrado, Charles Hulten & Daniel Sichel, *Intangible Capital and U.S. Economic Growth*, 55 REV. INCOME & WEALTH 661, 670 (2009).

262. *See supra* note 7 and accompanying text.

263. There may be instances in which an employer can prove that an employment noncompete has value before the restricted period because, for example, it increases the employer's ability to retain valuable employees. The burden to prove this ought to be high but, if met, might require allocation of more value to the noncompete and might support recovery over a period that begins before the employment relationship terminates.

detailed in Part I, employer investments in employment noncompete agreements generally are anti-competitive and produce harms for employees and the public. While tax law might aim to incentivize employer investments in other created intangibles through amortization rules that include taxpayer-friendly safe harbors for example, it ought not aim to incentivize employer investments in employment noncompetes.

IV. PROPOSAL

This Article proposes a change to the tax treatment of employment noncompetes. Instead of continuing to allow employers to immediately deduct the full compensation they pay to employees subject to noncompetes, the IRS should take a more aggressive stance and one that better comports with bedrock tax principles.

When an employer compensates an employee who is subject to a noncompete, the IRS should require that the employer establish what portion of compensation is allocable to the noncompete.²⁶⁴ The employer must establish the value of the noncompete, and therefore, the amount of compensation that should be deemed to pay for it. If the employer later brings a suit, claiming that an employee breached the noncompete and is liable for damages, then the employee should be permitted to obtain this allocation via discovery and to admit it into evidence as information relevant to damages.²⁶⁵

264. The IRS should require employers to disclose on each employee's W-2 form if that employee is covered by an employment noncompete. Even if state law makes an employment noncompete unenforceable in court, that noncompete should be disclosed and generally should be deemed to have value to the employer based on its ability to discourage an employee from changing jobs. *Cf.* *Flamingo Resort, Inc. v. United States*, 664 F.2d 1387, 1390 (9th Cir. 1982) (finding value for tax purposes in debts receivable from gambling customers even though state law made those debts unenforceable in court because "the taxpayer rarely had to resort to litigation to collect" the unenforceable obligations, and instead engaged in legally-unsanctioned enforcement efforts that by "its own estimates" resulted in collections "as high as ninety-six percent," leading the court to conclude that the value of these legally unenforceable obligations resulted from their high practical enforceability. As the court explained "it is doubtful that legal enforceability of the 'markers' would or could increase its recovery rate. . . . [meaning that the taxpayer's] inability to enforce its 'markers' in court is not a sufficient" basis to ignore their value.); Calvin Johnson, *supra* note 198, at 1387 (explaining that, even when unenforceable in court, a "gambling marker is an asset—a receivable—because of the respect given to it by the commercial market even without legal enforcement"). *But see* *Zarin v. Comm'r*, 916 F.2d 110 (3rd Cir. 1990) (holding that after a portion of a legally unenforceable debt was successfully disputed, cancellation of that portion did not give rise to cancellation of debt income); *Schlumberger Tech. Corp. v. U.S.*, 195 F.3d 216 (1999) (noting "critical difference between [legally unenforceable] disputed and [legally unenforceable] undisputed debts").

265. An employer who places a low value on a noncompete for tax purposes should have a more difficult time enforcing that noncompete against a former employee because the low value would tend to indicate that the noncompete is narrow (making it less likely that a court would enjoin competitive employment or find competitive employment to breach the noncompete) and of little value (causing low damage awards even if breach is found). *Cf.* Andrew Blair-Stanek, *Intellectual Property Law Solutions to Tax Avoidance*, 62 U.C.L.A. L. REV. 2, 19 (2015) (arguing that a multinational corporation that places

More importantly, the IRS should require employers to support the allocation with competent evidence about the value of the noncompete. This evidence likely will be difficult, but not impossible, to obtain. It will often depend on expert reports. It should be given more persuasive authority if it was disclosed to the employee before the employee executed the noncompete. The need to acquire this evidence will discourage employers from engaging in excessive use of employment noncompetes. Further, this evidence will help inform employees—who may underestimate the importance of noncompetes when they execute them—to better understand how valuable they are to employers, and how correspondingly costly they are to employees.

Then, the IRS should allow immediate deduction of only the portion of compensation not allocated to the noncompete. The portion of compensation allocated to the noncompete should be capitalized and amortized ratably over the restricted period, beginning when the employment relationship terminates.

Finally, if an employer fails to carry its burden of proof to establish what portion of compensation is allocable to the noncompete (and thus, capitalized and amortized over the restricted period) and what portion is not (and thus, eligible for immediate deduction), then the IRS should apply tax law's burden of proof rules to deny employers any deduction for the compensation they pay to employees subject to noncompetes.

Interestingly, this more aggressive stance is consistent with and would not require changes to the Internal Revenue Code. Arguably, it would not require changes to Treasury Regulations, either.²⁶⁶

a low value on an intellectual property asset for tax purposes should have a more difficult time enforcing that intellectual property against an "alleged infringer" because the low value would tend to indicate "the IP's invalidity, the lack of infringement, lower damages, the inappropriateness of injunctions, and inequitable behavior.")

266. It is not clear that an amendment to Regulation 1.263(a)-4(c)(3) is necessary because it is not clear that a noncompete is an intangible *acquired from* an employee. It is also not clear that an amendment to Regulation 1.263(a)-4(d)(6)(i)(C) is necessary because compensation paid to an employee subject to a noncompete ought not be deemed exclusively "reasonable compensation for services actually rendered" for reasons detailed in Section II.F (employers consistently assert that compensation is partially for the noncompete and partially for services actually rendered) and Section V.G (regardless of employers' assertions, tax law should independently find that compensation is partially for the noncompete and partially for services actually rendered). Finally, it is not clear whether an employment noncompete is "intrinsically capable of being sold, transferred or pledged . . . separate and apart from a

However, in an effort to provide fair notice to taxpayers of a significant change to the IRS's litigating position, and to clarify that existing Treasury Regulations cannot be read to allow immediate deduction of all compensation paid to employees subject to noncompetes, this Article proposes amendments to two *INDOPCO* regulations, Treasury Regulations 1.263(a)-4(c)(3) and 1.263(a)-4(d)(6)(i)(C).

Regulation 1.263(a)-4(c)(3) should be amended as indicated in brackets:

Intangibles acquired from an employee. Amounts paid to an employee to acquire an intangible from that employee are not required to be capitalized under this section if the amounts are includible in the employee's income in connection with the performance of services under section 61 or 83 [except to the extent that these amounts are paid to an employee who is subject to a noncompete, in which case an adequate amount of compensation must be allocated to the noncompete, capitalized, and amortized over the restricted period set forth in the noncompete].

Regulation 1.263(a)-4(d)(6)(i)(C) should be amended as indicated in brackets:

Except as otherwise provided in this paragraph (d)(6),²⁶⁷ a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party— . . . A covenant not to compete or an agreement having substantially the same effect as a covenant not to compete (except, in the case of an agreement that requires the performance of services, [the taxpayer must allocate an adequate amount of compensation to the covenant not to compete and then may deduct any remaining compensation] to the extent that the [remaining compensation] represents reasonable compensation for services actually rendered).

While existing regulations would allow the IRS to challenge employers when they immediately deduct the full compensation they pay to employees subject to noncompetes, the IRS has not advanced these challenges. Thus, the above regulatory amendments aim to provide notice that the IRS will begin advancing these challenges and will require employers to allocate a portion of compensation to the noncompete and to amortize that portion of compensation over the period benefited by the noncompete.

trade or business," as is required by the definition of separate and distinct intangible asset in Treasury Regulation § 1.263(a)-4(b)(3).

267. For exceptions based on the de minimis rule and the twelve-month simplifying convention, see *supra* note 188.

V. WHY TAX LAW IS A STRONGER APPROACH

By failing to challenge employers when they fully deduct the compensation they pay to employees who are subject to noncompetes, the IRS has allowed tax law to create significant subsidies for employment noncompetes. The proposal in this Article would convert tax law from a source of subsidy into a tool of resistance. There is reason to hope that the previously unused tool of tax law might be uniquely successful in curtailing excessive and harmful employment noncompetes because it avoids many of the pitfalls of contract-law-based approaches.

A. Consistency with Tax Law Principles

As was detailed in section II.A., contract-law-based approaches to curtailing noncompetes are in tension with foundational contract law principles that favor upholding written contracts between consenting adults, disfavor second-guessing the adequacy of consideration, and treat third-party interests and public interests as secondary to the wishes of the contracting parties. In contrast, tax-law-based approaches to curtailing noncompetes are in tension only with simplifying conventions won by lobbyists and adopted for the sake of convenience. Indeed, these approaches would represent a reassertion of fundamental tax law principles that require capitalization of costs that produce long-term benefits, aim to have costs recovered over the period that they produce benefit, treat immediate deductions as strictly construed exceptions to the norm of capitalization, and aim each year to tax employers on the net income they earn in that year.

B. Powerful Enough to Change Employer Behavior

As was detailed in Section II.C, contract-law-based approaches to curtailing noncompetes have failed, at least in part, because they rely on employees to act as private enforcers of the law. Even in the rare instances when an employee recognizes that she has a strong legal claim to set aside a noncompete, pays legal counsel, and wins, she is unlikely to deter her former employer from using overly broad noncompetes in the future.

Typical contract-law-based remedies for overly broad noncompetes include reforming the noncompete to make it lawful, or at worst, setting it aside.

In contrast, the tax-law-based approach proposed in this Article is likely to achieve far greater deterrence. Revenue agents are expert public enforcers of the law. They have access to paid legal counsel and are skilled at litigating valuation disputes. When they win, as they often do,²⁶⁸ they are likely to deter employers from using overly broad noncompetes in the future. Tax-law-based remedies will be imposed if the employer is found to have allocated insufficient value to a noncompete and will include a deficiency judgment,²⁶⁹ interest, and monetary penalties.

One might initially worry that simply changing the *timing* of when employers can deduct the amounts they pay to employees in exchange for noncompete provisions—but not changing either the fact of eventual deductibility or the total amount of deductibility—will be insufficient to change employer behavior. Some employers might be nearly as happy capitalizing and amortizing the costs of an employment noncompete as fully, immediately deducting them. After all, employers appear to be largely unaffected by changes to contract law rules affecting the legal enforceability of employment noncompetes,²⁷⁰ so they might be similarly unaffected by changes to tax law rules. However, as tax scholars have long recognized, the timing of when a cost can be deducted is nearly the whole ballgame.

When employers can immediately deduct the full cost of an investment that has long-term value, that treatment is equivalent to exempting the investment from tax.²⁷¹ Recall that time value of money considerations are strong enough to make traditional retirement accounts (whose deposits qualify for full, immediate deduction) as valuable as Roth retirement accounts (whose withdrawals are tax-exempt).²⁷² For this reason, disputes about the timing of when an employer may deduct a cost—not disputes about the fact of eventual deductibility or the total amount of deductibility—are the most common source of audits of large and mid-size businesses²⁷³

268. See, e.g., TAXPAYER ADVOCATE SERV., 2017 ANNUAL REPORT TO CONGRESS 349, https://taxpayeradvocate.irs.gov/Media/Default/Documents/2017-ARC/ARC17_Volume1.pdf [<https://perma.cc/S3ZB-GDXD>] (in cases involving the ten most litigated issues, taxpayers prevailed in whole or in part only 15% of the time if they were pro se and only 24% of the time if they were represented by counsel); *id.* at 350 (“Overall, the IRS prevailed in 89 percent of motions for summary judgment (97 cases) and in about 70 percent of bench opinions (65 cases).”).

269. If an employer allocates no or insufficient value to a noncompete, that employer will have immediately deducted too much employee compensation. That inflated deduction will cause the tax paid by the employer to be deficient when compared to the tax that should have been paid.

270. See *supra* note 143 and accompanying text.

271. See *supra* note 246 (explaining how and under what conditions the full, immediate deduction of a long-term investment is equivalent to exempting the yields on that investment from tax).

272. *Id.*

273. See, e.g., Lee, *supra* note 234, at 277 (“[O]ver the last decade, expensing versus capitalizing of costs with present and future, often intangible benefits became the most significant federal income

and “the issue with the most dollars at stake.”²⁷⁴ For example, looking solely at the 117 IRS Office of Appeals cases filed by large businesses in 1993, disputes about the timing of deductions accounted for “\$1.1 billion of the total \$1.9 billion in proposed tax adjustments.”²⁷⁵ The importance of timing to employers, coupled with the difficulty of meeting the burdens of proof that the proposal in this Article places on employers, are likely to be significant enough to change employer behavior and meaningfully discourage the excessive use of employment noncompetes.

C. Encourages Employers to Narrow Scope and Application

As was detailed in Section II.B., currently, employers have a largely unchecked incentive to write employment noncompetes as broadly as possible. This incentive has led to nearly one in five American workers being covered by an employment noncompete, even though many covered workers do not even have access to the trade secrets that their employers claim to be protecting via the noncompete. It also leads to noncompetes like the one previously used by Amazon that appear to cover a large range of competitive activities worldwide. Currently, if an employment noncompete is so broad as to be unlawful, employers still benefit because many workers are chilled from seeking competitive employment, few workers know when

tax issue in audits of big businesses, which report the bulk of both the corporate sector income and additional tax revenues raised by tax audits and collections.”); *id.* at 278 (explaining that “[b]etween 25% and 40% of the audit and litigation resources of the Large and Mid-Size Business unit (LMSB) of the Service” were devoted to expensing versus capitalization issues); Ethan Yale, *When Are Capitalization Exceptions Justified?*, 57 TAX L. REV. 549, 549 n.1 (2004) (noting that “approximately 25% of audit resources for large and mid-sized businesses are devoted to capitalization issues”) (citing John E. Hembera, *ABA Tax Section Meeting: Capitalization Issues on Front Burner, Olson Says*, TAX NOTES TODAY, Aug. 3, 2001, at 152-7).

274. Morrow, *supra* note 246, at 4 n.2 (quoting U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-95-232, TAX ADMINISTRATION: RECURRING ISSUES IN TAX DISPUTES OVER BUSINESS EXPENSE DEDUCTIONS 2 (1995)) (“In the 117 Office of Appeals cases, large corporate taxpayers disagreed with IRS most frequently over the issue of capital expenditures, which accounted for about 42 percent of the issues they contested. It was also the issue with the most dollars at stake in the 117 cases, accounting for \$1.1 billion of the total \$1.9 billion in proposed tax adjustments. In these cases, the corporations argued for immediate deduction of large expenses[,] . . . [while] IRS contended that such expenditures had future benefits and should therefore be treated as capital expenditures, not immediately deductible in the current tax year.”) (alterations in original).

275. *Id.*

noncompetes are unlawful, and even fewer workers bring legal challenges to set aside overly broad noncompetes. In those rare instances when an overly broad employment noncompete is successfully challenged in court, many courts bend over backwards using equitable reformation and blue-pencil doctrines to uphold a narrowed version of the unlawful noncompete agreement. In sum, employers enjoy the benefits of writing overly broad noncompetes and of imposing these noncompetes on an overly broad set of employees. Employers do not suffer the costs of overbreadth.

In contrast, tax-law-based approaches to curtailing noncompetes would cause employers to internalize at least some of the costs of overbreadth. An employment noncompete that restricts an employee from a broader range of activities (for example, manufacturing as well as distribution), or over a larger geographic range, or for a longer duration is a more valuable noncompete. With that increased value comes an increased allocation of compensation to the noncompete. With that increased allocation comes a decreased immediate deduction.

If the IRS required capitalization of compensation allocable to noncompetes, then employers seeking to immediately deduct as much compensation as possible would have a new incentive to write employment noncompetes as narrowly as possible. This incentive might not fully outweigh employers' competing incentives to write broader-than-necessary noncompetes, but it would at least partially counter those incentives. Perhaps most importantly, it would discourage employers from imposing noncompetes on employees who do not have access to trade secrets.

D. Resolves Uncertainty in Favor of the Vulnerable

Readers may worry that this proposal goes too far and that it will prevent even necessary and efficient noncompetes from being executed. As with any proposal, there are no facts about the future. However, even if this proposal discourages employers from using employment noncompetes when they would have been efficient and appropriate, employers can still protect their confidential information by enforcing intellectual property laws against their former employees.

Further, policies that are currently rare in the United States,²⁷⁶ but more common in places like England and New Zealand, can fill gaps in intellectual property law that are currently filled by employment noncompetes. Like employment noncompetes, so-called "garden leave" policies prevent a former employee from competing with her former employer for a set period of time. However, they are structured differently,

276. See THE WHITE HOUSE, *supra* note 135, at 9 ("Oregon is currently the only state that has some form of a 'garden leave' requirement.").

and in ways that better protect employees from exploitation.²⁷⁷ Garden leave policies keep former employees on the payroll for a set period of time following active employment in exchange for restricting them from obtaining new and competitive employment.²⁷⁸ Former employees are paid to stay home (out of the competitive workforce) and to “tend their gardens” during the time when their insider information is most threatening to their former employers. From the employee perspective, garden leave policies are less exploitative because they more transparently show how much an employee will be paid in exchange for refraining from competitive employment, require employers to bear direct costs to prevent competition, and discourage excessively long restrictions on competition.²⁷⁹ From a tax perspective, garden leave policies are unlike employment noncompetes because the timing of payment matches the timing of benefit. Each month, a former employer pays a former employee not to compete during that month and properly deducts that payment. To the extent that employers have legitimate claims that intellectual property laws offer insufficient protection of their inside information, garden leave policies allow them to buy more protection when appropriate and necessary.

Finally, even if the proposal advocated in this Article goes too far and under-protects employers while over-protecting employees, going too far is the right mistake to make as part of a search for an optimal balance between employer and employee interests. In an article that faced a similar dilemma—the dilemma of how to better protect currently under-protected wage claimants, tort claimants, and other involuntary and unsecured

277. *See id.* (“Post-employment compensation during the restricted period of a non-compete agreement, or what is more commonly referred to as a ‘garden leave’ provision, creates an incentive for employers to require non-competes only for those employees who pose a risk to the firm’s legitimate business interests. Because ‘garden leave’ constitutes a direct cost, employers are likely to be more cautious when deciding to include them in an employment contract.”); *id.* (Garden leave policies “create a cost mechanism that reduces the likelihood that non-compete agreements will be used unnecessarily.”).

278. *See, e.g., id.* (“[Oregon’s garden leave] statute ‘[p]rovides the employee, for the time the employee is restricted from working, the greater of compensation equal to at least 50 percent of the employee’s annual gross base salary and commissions at the time of the employee’s termination or 50 percent of the median family income for a four-person family’”) (alteration in original).

279. *See supra* note 277 and accompanying text (explaining how garden leave discourages overly broad restrictions on competition).

creditors “in a world of disputed theories and imperfect information”²⁸⁰—Elizabeth Warren thoughtfully suggests that we should err on the side of overcorrection. In *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, she proposes that we not resolve information gaps by favoring politically privileged groups and enacting change meekly, but that we resolve them by favoring politically disadvantaged groups and enact change meaningfully.²⁸¹ As Warren observes,

The group that profits from [the status quo] is well-funded and active, fully represented in all the policy debates and in the decisionmaking bodies. . . . If they—and all their academic supporters—make a persuasive case, they should win. But if they do not, then the party who has not had the opportunity to make its case should win. In the case of a tie, the unfunded, the unheard, and the unorganized should be declared the winners.²⁸²

Just as “[t]he lawyers of commercial lenders ably explain their views about how a shift away from full priority will cause their clients to alter their lending practices and constrict credit, thereby hurting all businesses,”²⁸³ representatives of employers ably explain their views about how a shift away from employment noncompete protections will cause employers to alter their training practices and reduce innovation, thereby hurting all businesses. Less is heard from unfunded and unorganized groups of employees. Thus, when information is incomplete, it is appropriate that policymaking err on the side of benefiting unfunded, unheard, and unorganized employees and that overcorrections be moderated as more complete information becomes available.

E. Provides Employer-Funded Information to Guide Reform

As was noted earlier, the information-providing task that this proposal puts on employers is heavy.²⁸⁴ As the bearers of the burden of proof, employers will have to hire experts to allocate a portion of aggregate compensation to the employee’s noncompete, and to resolve difficult questions about whether that portion is fixed, or whether it decreases over time as the employer pays higher compensation for a greater number of years to compensate for the same restricted period, or whether it increases as the competitive employment opportunities available to an employee grow

280. Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1374 (1997).

281. *Id.* at 1394.

282. *Id.*

283. *Id.*

284. *See supra* Section IV.

more valuable. The burden of valuing noncompetes is heavy, and it is right that this heavy burden rest primarily with the employer. Placing this burden on the employer is consistent with tax law because it treats capitalization as the norm and deductibility as the exception to that norm. Further, placing this burden on the employer is consistent with broader equitable considerations because employers are the parties who want to use noncompetes.

If, after implementing the policy proposed in this Article, experience demonstrates that it is overly hostile toward noncompetes, stifling training and innovation to a greater extent than it fosters lawful knowledge-sharing, wage competition, and employee mobility, then by all means, it should be moderated.

In that case, the employer-funded information about how employment noncompetes ought to be valued will help guide better reforms than can be enacted currently. For example, the Department of Treasury could use the newly available data valuing noncompetes to make it easier for employers to use them appropriately. Treasury might establish safe harbors providing that if a minimum specified percent of compensation is allocated to a standardized noncompete provision,²⁸⁵ then the employer will be deemed to have allocated adequate value to the noncompete and can then confidently deduct the remaining compensation. Tax law often suggests standardized provisions to resolve difficult valuation disputes and provides preferential tax treatment in exchange for using a standardized provision.²⁸⁶ These safe harbors might provide the additional benefit of encouraging employers to

285. An alternative safe harbor might specify a minimum percent of compensation to be allocated to a noncompete for each month of the restriction period.

286. For example, 26 U.S.C. § 2702 is a taxpayer-unfriendly provision that generally values retained interests in property at zero, making the full value of the property included in the gifted or bequeathed estate. However, it also includes taxpayer-friendly safe harbors that will value the retained interest as greater than zero provided it is structured in a specified form to make valuation easier. The standardized retained interest can be the right to receive: 1) “fixed amounts payable not less frequently than annually,” 2) “a fixed percentage of the fair market value of the property in the trust (determined annually),” or 3) any “noncontingent remainder” of the rights 1) and/or 2). 26 U.S.C. § 2702(b)(1)–(3) (2016). This provision encourages taxpayers to simplify otherwise thorny valuation questions by structuring transfers into standardized forms like Grantor Retained Annuity Trusts (GRATs), Grantor Retained Unitrusts (GRUTs), Grantor Lead Annuity Trusts (GLATs) and Grantor Lead Unitrusts (GLUTs), for which the IRS can issue standardized valuation tables. Similar rules encourage the creation of standardized charitable transfers, including CRATs, CRUTs, CLATs, and CLUTs.

use standardized noncompetes, which would increase employee understanding of noncompetes, enable employees to compare noncompetes proposed by competing prospective employers, and increase employees' ability to predict when standardized noncompetes will be judicially upheld or set aside. Regardless of whether a safe harbor is later implemented, an appropriate safe harbor can only be established using good evidence of the value of noncompetes. By allowing employers to fully deduct all compensation paid to employees covered by noncompetes, and by not requiring any allocation of value to the noncompetes, the IRS has forfeited an opportunity to begin collecting this valuable data.

F. Properly Rejects Accelerated Recovery

Readers familiar with trends in tax law will note that, while matching cost recovery with the period benefited by the cost is a key principle of a normative income tax, the United States has spent decades moving away from this key principle and away from a normative income tax. From the modified accelerated cost recovery system,²⁸⁷ to bonus depreciation,²⁸⁸ to immediate expensing,²⁸⁹ modern tax laws have intentionally permitted cost recovery before the period benefited. These and other accelerated cost recovery provisions reflect lawmakers' collective desire to incentivize taxpayers to invest more in long-term assets. Lawmakers use incentives that collapse the fundamental distinction between expenses and expenditures and sacrifice the matching principle. This trend is significant. For example, the Tax Cuts and Jobs Act, enacted on December 22, 2017, increased bonus depreciation to 100% (making certain otherwise depreciable expenditures eligible for full, immediate deduction)²⁹⁰ and increased immediate expensing to \$1,000,000 (allowing taxpayers to treat certain otherwise depreciable expenditures as though they were currently deductible expenses).²⁹¹

However, even given this trend, tax law has not abandoned matching. If it does, the United States will cease to have an income tax and will instead

287. 26 U.S.C. § 168(a) accelerates depreciation in many ways, including by adopting recovery periods that are intentionally shorter than the useful lives of depreciable assets, thus earning the statute's title Modified Accelerated Cost Recovery.

288. 26 U.S.C. § 168(k) allows taxpayers to take an additional percentage of bonus depreciation in the year an asset is acquired.

289. 26 U.S.C. § 179 allows taxpayers to immediately expense a large amount of assets that would otherwise be gradually depreciable.

290. 2017 Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13201, 131 Stat. 2105 (increasing § 168(k) bonus depreciation).

291. *Id.* § 13101, 131 Stat. at 2101 (increasing § 179 immediate expensing).

have a consumption tax.²⁹² Rather, the United States currently uses a hybrid system applying immediate or accelerated cost recovery to certain long-term assets and gradual or delayed cost recovery to others. To give a long-term investment immediate or accelerated cost recovery is to make that investment tax-advantaged and to distort investing toward it.²⁹³ Thus, the United States has recently distorted investing toward long-term investments that are eligible for bonus depreciation and immediate expensing, like machinery and equipment.²⁹⁴

There is—and should be—no similar desire to increase employers' investing in employment noncompetes. Policymakers have clearly evidenced a desire to decrease employers' investing in noncompetes by enacting various contract-law-based approaches to curtail their use. As Part I detailed, employment noncompetes are currently excessively used to the point that they cause significant growth, distributional, and ethical harms. Thus, employer investments in noncompetes should not be incentivized. Even in an era when tax law increasingly compromises its matching principle, it should not compromise—and should begin insisting on—matching for employment noncompetes.

G. Properly Reflects the Value of Noncompetes

This Article began with an analogy to Al Capone. It argues that since employers in contract law disputes assert that they adequately compensate

292. See, e.g., Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 20 (1996) (explaining that the difference between a consumption tax and an income tax is that “[u]nder the [consumption tax imposed on] cash flow . . . all capital investment is deducted, or expensed, when made, while under an income tax, capital investment is recovered through depreciation deductions or upon disposition”).

293. Yale, *When Are Capitalization Exceptions Justified?*, *supra* note 273, at 550 (arguing that capitalization and economic depreciation are normative or first-best rules for an income tax, meaning that deviations should be rare and narrow).

294. See, e.g., JANE G. GRAVELLE, CONG. RESEARCH SERV., R43432, BONUS DEPRECIATION: ECONOMIC AND BUDGETARY ISSUES 7 (2014) (“Because expensing applies only to equipment, it increases the distortion between tax burdens on equipment and structures.”); GARY GUENTHER, CONG. RESEARCH SERV., RL31852, SECTION 179 AND BONUS DEPRECIATION EXPENSING ALLOWANCES: CURRENT LAW, LEGISLATIVE PROPOSALS IN THE 113TH CONGRESS, AND ECONOMIC EFFECTS 14 (2013) (“The Section 179 and bonus depreciation expensing allowances have the potential to distort the allocation of resources in an economy by driving a wedge between favored assets and all other assets regarding their profitability.”).

their employees for being subject to noncompete restrictions, they should be bound by this assertion in tax law. They should be required to allocate adequate compensation to the noncompete and capitalize and amortize it, rather than immediately deduct it. But not every employer is involved in a contract dispute, not every employer would necessarily assert that it adequately compensates its employees for noncompete restrictions, and some might even claim that any compensation they pay for the noncompete is a mere peppercorn of consideration. Indeed, at least one study finds that employees are paid *less* when they are subject to a noncompete,²⁹⁵ lending support to the possibility that claims of adequate compensation are self-serving and false.

If employers are willing to oppose the proposal in this Article by arguing that they provide no (or only *de minimis*) consideration in exchange for an employment noncompete agreement, then there is benefit to publicly exposing their argument. It reveals the inconsistency between the contract law view of employment noncompetes and the tax law view. Further, workers who are sued for breach of employment noncompetes should be allowed to request discovery and present evidence that, for tax purposes, their employers treated their noncompetes as having no value.

However, even if employers collectively reverse their public position and deny that they meaningfully compensate their employees for being subject to noncompetes, it does not follow that noncompetes cease to be intangible assets with significant future value. Actual value is not conclusively established by the self-serving testimony of the purchaser. Moreover, tax law sometimes sets aside values that were agreed to by both parties to a contract when the agreed-upon value was not the product of informed, adversarial bargaining.²⁹⁶ Instead, tax law establishes value based on “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”²⁹⁷ If an employer purchased a noncompete agreement from a willing employee who was not under compulsion to sell and who had reasonable knowledge of relevant

295. Garmaise, *supra* note 89, at 401–02, 413 (finding that with regard to executive compensation, employment noncompetes may be associated with larger signing bonuses and/or higher initial compensation, but they are also associated with smaller raises and lower overall compensation).

296. Prior to the enactment of § 197, for example, the IRS often challenged values for items like goodwill and customer lists that were contractually agreed-upon between business buyers and business sellers since business sellers had insufficient incentive to counter business buyers’ desires to allocate as much value as possible to intangibles that are recovered quickly. *See, e.g., supra* note 190 (citing *Ill. Cereal Mills Inc. v. Comm’r*, 46 T.C.M. (CCH) 1001 (1983) (IRS argued that the business sale contract allocated too much value to the seller’s covenant not to compete with the buyer)).

297. *United States v. Cartwright*, 411 U.S. 546, 551 (1973) (quoting Treas. Reg. § 20.2031-1(b)); *see also id.* (“The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves . . .”).

facts, the employee would demand adequate compensation. Thus, tax law demands adequate allocation of value to employment noncompetes based on its own objective definition of fair market value. It does not depend on employers' contract-law-based claims that they adequately compensate their employees for being subject to noncompetes. These contract-law-based claims merely strengthen the argument.

CONCLUSION

When an employer obtains a noncompete agreement from its employee, it obtains an intangible asset that will benefit the employer primarily after the employment relationship ends, and gradually over the restricted period. As the employer benefits, both the employee and the public suffer. Thus, it is disappointing that, quietly and carelessly, the IRS allows employers to take a tax subsidy for subjecting an ever-increasing number of American workers to noncompetes. This subsidy occurs when employers immediately deduct the full compensation they pay to employees subject to noncompete agreements as though that compensation was not even partially associated with their acquisition of future benefits. This subsidy should end.