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Income Taxation—Sale of a Business—Covenant Not to Compete—Tax Consequences of Unrealistic Covenant.—Commissioner v. Danielson

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generally have been defined as "ordinary and necessary business" expenses under this section, and the expenses incurred in selling capital assets pursuant to liquidation would seem to be similarly within that section's phraseology.

Where expenditures made pursuant to selling capital assets are incurred in liquidation proceedings under section 337, however, the counterargument is met by the second line of reasoning supporting *Alphaco*. This line of reasoning is based on the premise that to allow the expenses as section 162 deductions would frustrate the legislative intent of section 337 by requiring the precise fact-findings which that section was designed to eliminate. It is submitted that, on the basis of this contravention-of-purpose argument, the *Alphaco* court was correct in holding that expenses incurred in the sale of capital assets pursuant to liquidation qualifying under section 337 are not deductible under section 162.

DAVID M. WINER

Income Taxation—Sale of a Business—Covenant Not to Compete—Tax Consequences of Unrealistic Covenant.—*Commissioner v. Danielson.*[1]— Taxpayers, stockholders of Butler Loan Company, sold their interests in the corporation to Thrift Investment Corporation for $374 per share. The contract of sale stated that $222 per share represented the equity interest and $152 was consideration for a covenant not to compete. Under such a contract, taxpayers would normally have been required to pay capital gains tax on $222 per share and ordinary income tax on the balance.[2] They nevertheless reported the entire amount as payment for the equity interest and paid a capital gains tax on $374 per share. The Commissioner assessed a deficiency, asserting that the $152 figure should have been treated as payment for the covenant not to compete, that is, as ordinary income. Taxpayers petitioned for a redetermination of the deficiency. They claimed that Thrift had bargained for the restrictive covenant solely for the purpose of gaining the opportunity to amortize the amounts allocated to the covenant.[3] Taxpayers further alleged that the covenant did not really restrict competition, and that in any event taxpayers never had the ability to compete. From these facts, they argued that the amounts paid for the covenant not to compete were in reality paid for the equity interest, and hence were properly treated as payment for a capital asset. The Tax Court adopted this reasoning and found for taxpayers.[4] On the Commissioner's petition for review, the Court of Appeals for the Third Circuit, in a four to three decision, reversed. HELD: A taxpayer cannot attack the tax consequences of his own written agreement unless he can show that the writing does not express the intention of the parties or that he was in-

[1] 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967).

[2] Money received for an agreement not to compete is ordinary income, while money received for sale of the equity interest in a corporation is capital gains. See Ullman v. Commissioner, 264 F.2d 305, 307-08 (2d Cir. 1959).

[3] The amount paid for a covenant not to compete can be amortized by the buyer over the period during which the covenant restricts competition by the seller. Id. at 307-08.

[4] Carl L. Danielson, 44 T.C. 549 (1965).

duced to enter the agreement by "mistake, undue influence, fraud, duress, etc."[5]

The majority supported this holding with two policy reasons. First, if a party to a contract were allowed to claim that its form is unrealistic, the Commissioner would become involved in so much litigation that efficiency in collecting taxes would be greatly hampered. Second, to permit such a claim would be, in effect, to allow a unilateral reformation of the contract, and would result in a shifting of bargained-for tax consequences without any representation of the other party to the contract. The dissent did not accept the policy considerations of the majority, but contended that, since the holding permitted the unrealistic form of the contract to control, it contravened the well-established doctrine that substance must rule over form in tax matters.[6]

The majority's two policy statements point out the necessity of having the terms of a contract determine its tax consequences in most of the cases where the contract is the product of bargaining by parties with adverse tax interests. First, when parties with adverse tax interests agree to cast their transaction in a certain form for tax purposes, the Commissioner will have greater difficulty in collecting taxes if one of the parties can request a court to disregard the form of the transaction in determining its tax consequences. The Commissioner might well find himself litigating with both parties—one claiming that the form of the contract is economically unreal and the other claiming that the contract is economically real.

Second, when parties have competing tax interests, they will not receive what they bargained for unless the form of their contract controls the transaction's tax results.[7] This can be demonstrated with the following hypothetical—one which closely parallels the *Danielson* situation. After Buyer and Seller agree to a sale of Seller's corporation for $200 per share, Buyer requests that $100 per share be allocated to a covenant not to compete. Buyer, knowing Seller cannot compete anyway, makes this request solely for the purpose of gaining the opportunity to amortize the $100 allocated to the restrictive covenant. Seller, knowing of Buyer's reason and realizing both this and the fact that he will have to treat the amount allocated to the covenant as ordinary income, informs Buyer that he will agree only if the total purchase price is increased so that he will receive the same amount after taxes as if there were no allocation. Seller calculates a new purchase price in the following manner: Since he is in the 50 percent tax bracket and capital gains are taxed at a rate of 25 percent, his income after taxes would be $150 per share if the sale price were $200 per share and there were no restrictive covenant.[8] On the other hand, if $100 per share were allocated to a covenant not to compete, the total contract price would have to be raised to $233 for him to receive $150 after

[5] 378 F.2d at 775.

[6] Id. at 779.

[7] This, of course, would not be the case if a party were induced to enter the contract by fraud, mistake, duress, or undue influence.

[8] If the total purchase price is $200 per share and there is no allocation to a covenant not to compete:

Income per share	Tax rate	Taxes per share
$200	25%	$50

Income per share after taxes: $200 — $50 = $150.

taxes.[9] When Seller offers to allocate $100 to a restrictive covenant if Buyer raises the total price to $233 per share, Buyer accepts, believing that the opportunity of amortizing $100 per share is worth the payment of an extra $33 per share.

In this hypothetical, Seller will receive exactly what he bargained for—$150 per share after taxes—only if the unrealistic covenant is used to determine the tax consequences. If, however, Seller is permitted to avoid the tax results of the restrictive covenant he will receive more than he bargained for.[10] Furthermore, the Commissioner will then probably not allow Buyer to amortize the money allocated to the covenant not to compete.[11] As a result, Buyer will receive less than he bargained for. The hypothetical is a situation likely to occur if parties with adverse tax interests include an economically unreal covenant in their contract, for those who enter a transaction involving large sums of money such as the sale of a business usually receive tax advice. If a seller knows that his taxes will be increased because of the inclusion of a certain covenant, he will certainly not agree to it unless he receives a higher purchase price. Since the tax consequences of a contract's unrealistic form are likely to be bargained for, then, as the majority held, there is no policy reason or consideration of fairness to the taxpayer which dictates that substance govern form.

There is, however, the possibility that a seller would not know of the tax consequences of a restrictive covenant. If he did not have such knowledge he would probably not have bargained for a higher price upon the buyer's request to allocate a portion of the purchase price to the covenant. In this situation it would not be inequitable for the seller to treat the amount allocated to the restrictive covenant as capital gains, because he, unlike Seller in the hypothetical, did not promise the buyer to treat the allocation as ordinary income. Therefore, it is submitted that the majority should have made an exception to its rule so as to allow a taxpayer to attack the form of his contract on showing that (1) the tax consequences of the form were not bargained for, and (2) the form of the contract is economically unreal. This exception would not run counter to the majority's policy of preventing

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[9] If $100 per share is allocated to a covenant not to compete, and the total purchase price is $233 per share:

	Income per share	Tax rate	Taxes per share
Equity	$133	25%	$33
Covenant	100	50%	50
Totals	$233	—	$83

Income per share after taxes: $233 — $83 = $150.

[10] If $100 per share is allocated to a covenant not to compete, and the total purchase price is increased to $233 per share, and if Seller is allowed to avoid the tax consequences of the covenant, he will receive more than the $150 per share that he bargained for:

Income per share	Tax rate	Taxes per share
$233	25%	$58

Income per share after taxes: $233 — $58 = $175.

[11] Particelli v. Commissioner, 212 F.2d 498 (9th Cir. 1954). Cf. Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962); Schulz v. Commissioner, 294 F.2d 52 (9th Cir. 1961).

the Commissioner from having too much difficulty in collecting taxes, because it would be very rare that a seller would not know of the tax consequences of the sale of his business. Thus the amount of litigation that the Commissioner is engaged in will not be greatly increased.

The dissent contended, in effect, that legal precedent requires that form must never control tax results, citing six Supreme Court cases.[12] Four of the cases—*Eisner v. Macomber*,[13] *Weiss v. Stearn*,[14] *Gregory v. Helvering*,[15] and *Helvering v. Tex-Penn Oil Co.*[16]—are, however, factually distinguishable from *Danielson* in that they did not involve transactions between parties having adverse tax interests. All four of these cases involved dealings between shareholders and their own corporations. In *Eisner*, the transaction was a stock dividend, while in the three other cases it was a corporate reorganization, and thus the Court never considered, as did the court in *Danielson*, whether a taxpayer who might have received consideration for placing his transaction in a form giving him a tax disadvantage, could request a court to disregard the unrealistic form.

The fifth case cited by the dissent, *Helvering v. F. & R. Lazarus & Co.*,[17] can be distinguished on essentially the same grounds, though it is possible to read the facts as indicating that the parties to the transaction did have adverse tax interests. The taxpayer had sold property to a bank and leased it for 99 years with an option to renew. A deduction claimed by the taxpayer for the depreciation of the property was disallowed by the Commissioner on the ground that the statutory right to the deduction is vested in the party with legal title. The Supreme Court held that the taxpayer was entitled to the deduction because the sale and lease-back arrangement was in reality a mortgage, and substance not form should control in tax matters. It appears that the bank might have cast the transaction in the form of a sale and lease-back instead of a mortgage so that it would receive the depreciation deduction. If this were so, the *Lazarus* decision would be in direct conflict with *Danielson*, because the court would have held that the unrealistic terms of the transaction

[12] The dissent also argued that the court is compelled by the Int. Rev. Code of 1954, § 7453, to allow a taxpayer to challenge the tax consequences of his written agreement by showing that its form is economically unreal. This section requires that the Tax Court be conducted "in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia." Id. From this, the dissent argued that, since the majority's rule is merely a restatement of the parol evidence rule, and since according to Landa v. Commissioner, 206 F.2d 431 (D.C. Cir. 1953), the parol evidence rule cannot be invoked by the Commissioner against a taxpayer in the District of Columbia, the parol evidence rule cannot be invoked by the Commissioner in the *Danielson* case. This argument of the dissent is easily refuted even if the majority's rule is the same as the parol evidence rule, because of wide recognition that the parol evidence rule is not a rule of evidence but a rule of substantive law. 3 A. Corbin, Contracts § 573 (1960); C. McCormick, Handbook of the Law of Evidence § 213 (1954); 1 Restatement of Contracts § 237 (1932); 9 J. Wigmore, A Treatise on the Anglo-American System of Evidence in Trials at Common Law § 2400 (1940); 4 S. Williston, A Treatise on the Law of Contracts § 631, at 955 (3d ed. 1961).

[13] 252 U.S. 189 (1920).

[14] 265 U.S. 242 (1924).

[15] 293 U.S. 465 (1935).

[16] 300 U.S. 481 (1937).

[17] 308 U.S. 252 (1939).

must be disregarded even if the taxpayer might have received consideration to place the transaction in that form. This, however, was not the holding of *Lazarus*. Although the bank would be in a better position tax-wise if it received the depreciation deduction, the transaction was not placed in the form of sale and lease-back for the purpose of giving the bank the deduction. Rather, the transaction was carried out that way only because of the lack of a market at the time for mortgage notes.[18] Furthermore, it is not suggested in the case that the bank gave the taxpayer consideration for using the sale and lease-back method instead of the mortgage. Thus the *Lazarus* court never considered the question of whether the unrealistic form of a transaction ought to determine its tax consequences where consideration was given to place the transaction in that form.

Only one of the cases cited by the dissent in support of the substance-over-form rule involved a bargain by adverse parties for the shifting of tax burdens. In *Bartels v. Birmingham*,[19] a ballroom owner hired the services of a bandleader and his musicians by signing a contract which stated in part that the ballroom owner and not the bandleader was the musicians' employer. If the Supreme Court had allowed the agreement to govern the case, the owner would have been liable for the payment of Federal Insurance Contributions Act taxes.[20] The Court concluded, however, that Congress had intended to tax the bandleader, for he was the person who in substance was the employer and he was not to be allowed to contract away his obligation. Despite the similarity of the issues in *Bartels* and *Danielson*, it must be noted that the statutes involved in the two cases are substantially different. The income tax contemplates the taxation of the results of widely differing kinds of transactions, while the Federal Insurance Contributions Act is involved only with the taxation of a clearly defined and relatively easily recognized relationship. In the latter situation the application of the substance-over-form doctrine results in uniformity and certainty, but in the former it requires a court to make a lengthy examination of cloudy facts to arrive at an unpredictable result.[21] This distinction strongly militates against the wholesale importation of the *Bartels* holding into the *Danielson* situation.

It would appear, then, that the six cases upon which the dissent relied are fairly distinguishable from the *Danielson* case. For that reason, the dissent should have inquired whether the reasoning which supports the substance-over-form doctrine can be applied to the facts of *Danielson*. Because this was not done, its reasoning is suspect.

Although the *Danielson* holding, strictly speaking, refers only to challenges of the form of a transaction by a taxpayer, a similar rule concerning the Commissioner may be necessary. Since the court was attempting to prevent the buyer's losing his bargained-for tax advantage in *Danielson*, it would be defeating the court's purpose to allow the Commissioner both to disregard the form of the transaction on the ground of economic unreality and to dis-

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[18] F. & R. Lazarus & Co., 32 B.T.A. 633, 637 (1935).

[19] 332 U.S. 126 (1947).

[20] 26 U.S.C. § 3111 (1964).

[21] For further discussion of the policies behind the interpretation of the word "employer" under the F.I.C.A., see United States v. Silk, 331 U.S. 704 (1947).

allow the buyer's amortization of the allocation to the restrictive covenant. The court made reference to this when it stated that "where a loss of tax revenues from one taxpayer cannot be retrieved entirely from another because of differentials in tax brackets or other factors the Commissioner may challenge the allocation as not reflecting the substance of the transaction."[22] It would seem that this ought to be the only situation in which the Commissioner can attack an allocation in a contract for sale of a business. If the amount of taxes that will be collected from both parties when their contract is cast in economically unreal form is not less than the amount that would have been collected if the contract were cast in an economically real form, there is no reason for the Commissioner to deny a taxpayer the tax benefits of the economically unreal form. If the Commissioner were to deprive him of these benefits and at the same time require the other party to the contract to bear the tax burdens of the unrealistic form, then the Commissioner would be collecting more taxes than he would have collected if the contract had been cast in a form which had economic reality. Therefore, to prevent such a result, a rule that the Commissioner can disregard the form of a taxpayer's contract only when the taxpayer's tax savings are greater than the increased taxes assessed upon the other party to the contract is a necessary complement to the court's rule in *Danielson.*

GERALD J. HOENIG

Labor Law—Labor Management Relations Act—Section 8(b)(4)(ii)(B) —Limitations on Product Picketing.—***Honolulu Typographical Union No. 37.***[1]—Hawaii Press Newspaper, Inc. publishes a group of newspapers, one of which is the Waikiki Beach Press. Since June, 1963, a labor dispute involving a strike and picketing has existed between Hawaii Press and the Honolulu Typographical Union No. 37. At least six shops in the International Market Place, a privately owned shopping center consisting of fifty to sixty shops, are regular advertisers in the Waikiki Beach Press. On three separate dates, the Union in support of its dispute with Hawaii Press picketed and distributed handbills to the public at the entrance to the shopping center. Each of the pickets carried a placard identifying one of the five shops located in the Market Place. The placard stated that the named shop advertised in the struck Waikiki Beach Press and requested the public not to buy any of the shop's products advertised in the Press. Four of these five shops were restaurants which advertised their entire business, rather than a particular product. Hawaii Press charged that this picketing was a violation of Section 8(b)(4)-(ii)(B) of the National Labor Relations Act.[2] The National Labor Relations Board HELD: (4-1) Picketing by a striking newspaper union of a service establishment which advertises its whole business in the struck newspaper is not allowable secondary activity under section 8(b)(4)(ii)(B).[3]

[22] 378 F.2d at 778.

[1] 167 N.L.R.B. No. 150, 66 L.R.R.M. 1194 (1967).
[2] 29 U.S.C. § 158(b)(4)(ii)(B) (1964).
[3] 167 N.L.R.B. No. 150, at 3, 66 L.R.R.M. at 1195.