PennState Dickinson Law

DICKINSON LAW REVIEW
PUBLISHED SINCE 1897

Volume 72
Issue 2 *Dickinson Law Review - Volume 72, 1967-1968*

1-1-1968

Commissioner v. Danielson: Taxpayer May Not Challenge Consideration Allocated to Covenant Not to Compete

Follow this and additional works at: https://ideas.dickinsonlaw.psu.edu/dlra

Recommended Citation

Commissioner v. Danielson: Taxpayer May Not Challenge Consideration Allocated to Covenant Not to Compete, 72 DICK. L. REV. (1968).
Available at: https://ideas.dickinsonlaw.psu.edu/dlra/vol72/iss2/9

This Article is brought to you for free and open access by the Law Reviews at Dickinson Law IDEAS. It has been accepted for inclusion in Dickinson Law Review by an authorized editor of Dickinson Law IDEAS. For more information, please contact lja10@psu.edu.

COMMISSIONER v. DANIELSON: TAXPAYER MAY NOT CHALLENGE CONSIDERATION ALLOCATED TO COVENANT NOT TO COMPETE ABSENT SHOWING OF FRAUD, DURESS OR UNDUE INFLUENCE

In *Commissioner v. Danielson*[1] the United States Court of Appeals for the Third Circuit held that a taxpayer may not challenge, for tax purposes, the consideration specifically allocated to a covenant not to compete absent a showing of fraud, duress or undue influence on the part of the other party to the covenant.[2] This decision is a departure from the majority rule which only requires the taxpayer to adduce "strong proof" to overcome the allocation. Upon first impression this holding would seem to violate the principle of deciding questions of taxation according to truth and substance without regard to form.[3] Upon closer analysis, however, the rule appears justifiable because of the special problems involved in tax treatment of covenants not to compete. By honoring the parties' price allocation in the covenant, the *Danielson* court attempted to achieve predictability of tax treatment in an area currently marked by many conflicting and confusing decisions. This Note will analyze the *Danielson* rule in light of prior case law on the degree of proof required to challenge the consideration allocated to a covenant not to compete and will evaluate its soundness and probable consequences.

The taxpayers, stockholders in a small loan business, solicited offers for its sale. Thrift Investment Corporation offered to buy all the outstanding common stock along with a covenant not to compete for $374 per share. Thrift explained that its offer was higher than it would otherwise have been because it was passing on to the vendors part of the favorable tax benefits which would accrue. That is, because Thrift would be able to amortize the cost of the covenant not to compete,[4] it was willing to pay a higher total purchase price.[5]

---

1. 378 F.2d 771 (3d Cir.), *cert denied*, 88 S. Ct. 94 (1967).
2. *Id.* at 777. The case was remanded to permit the parties a further opportunity to produce evidence in accordance with this ruling.
3. The three dissenting judges relied on the principle that the substance of a transaction should always control form. Since the taxpayers had established that the allocations did not reflect the substance of the agreement, the dissent would have affirmed the tax court's judgment allowing the taxpayers to successfully challenge their agreement. 378 F.2d at 783 (dissenting opinion).
4. *See* note 18 *infra* and accompanying text.
5. *See* note 60 *infra* and accompanying text.

The proposed stock purchase and non-competition agreements were drafted by Thrift. The covenant restricted the stockholders from engaging in the small loan business around Butler, Pennsylvania, for approximately six years, but permitted them to own stock of any small loan corporation.[6] The agreement was silent concerning the portion of the total consideration to be allocated to the covenant not to compete. At the time of settlement, all the stockholders and their attorneys were present along with representatives of Thrift.

Thrift unilaterally allocated $152 per share to the covenant not to compete and $222 per share to the contract for the sale of stock. After these figures were inserted in the documents, the vendors inquired about the tax treatment they would receive on the $152 per share allocated to the covenant. Thrift said the allocations were to its tax advantage, but made no attempt to explain that such amounts would be taxable to the vendors as ordinary income.[7] Thrift did not, however, lead the vendors to believe that they would receive capital gains treatment.[8] The vendors discussed the allocation with their attorney and signed the agreements on his advice.

On their tax returns all the stockholders reported their share of the amount received as proceeds from the sale of capital assets. The Commissioner determined that the amount attributed to the value of the stock was properly reported, but designated the amount allocated to the covenant not to compete as ordinary income. A deficiency notice was issued and the taxpayers petitioned for a redetermination.

In the tax court, the Commissioner urged the adoption of a "new rule" of law concerning the treatment of written covenants not to compete. The proposed rule would have prevented either contracting party or the Commissioner from subsequently attacking the stated consideration in such agreements unless fraud, duress or undue influence existed at the time they were signed.[9] The taxpayers, knowing that if the covenant stood it would result in ordinary income to them, wanted the total purchase price allocated to the stock—a capital asset.[10] Therefore, they contended that the amount assigned to the covenants did not reflect the real agreement of the parties.

---

6. This fact was viewed by the tax court as an indication that the covenants were not fully restrictive. *See* Carl L. Danielson, 44 T.C. 549, 556 (1965).

7. *See* notes 14 & 15 *infra* and accompanying text.

8. *See* note 20 *infra* and accompanying text.

9. Adoption of this rule was first advocated in Note, *Tax Treatment of Covenants not to Compete: A Problem of Purchase Price Allocation*, 67 YALE L.J. 1261, 1268 (1958). This was the only mention of the "new rule" until its adoption was urged by the Commissioner in *Danielson*.

10. Then they could show capital gains to the extent that the amount of money received exceeded the bases. See INT. REV. CODE OF 1954, §§ 1011, 1016.

After finding that the covenants were not fully restrictive,[11] that none of the stockholders were realistically in a position to compete,[12] and therefore that the covenants lacked an independent basis in fact,[13] the tax court said the taxpayers had sufficiently established by "strong proof" that the price allocated to the covenants did not reflect the substance of the parties' agreement.[14] They held that the amount specifically allocated as payment for each vendor's covenant not to compete should not, for tax purposes, be treated as having been received for the covenants.

The court of appeals accepted the factual findings of the tax court, but vacated the decision and remanded on the basis of their adoption of the rule that a taxpayer should be held to the allocations set forth in his contract as written absent a showing of fraud, duress or undue influence.

TAX TREATMENT OF COVENANTS NOT TO COMPETE

The sale of a business with a covenant not to compete produces conflicting tax consequences to the vendor and vendee. Payments received by the vendor for his covenant are taxable as ordinary income.[15] The rationale for this treatment is that the covenantor

11. The covenants were not fully restrictive because they contained nothing to prevent the stockholders from later establishing a small loan company to duplicate, for all practical purposes, the business they sold. Carl L. Danielson, 44 T.C. 549, 556 (1965).

12. When the agreements were executed, one of the stockholders was a 93 year old retired businessman who rarely left his home and whose affairs were conducted by his wife. Three stockholders were housewives with no knowledge of the small loan business and another was in the real estate business 60 miles beyond the area covered by the covenant. The remaining stockholder was a busy and successful surgeon. Carl L. Danielson, 44 T.C. 549, 557 (1965).

13. The standard used by the tax court to determine whether the covenant reflected the substance of the agreement was that "the covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement." Carl L. Danielson, 44 T.C. 549, 556 (1965). The first case to apply this test was Schulz v. Commissioner, 294 F.2d 52 (9th Cir. 1961), *aff'g* 34 T.C. 235 (1960).

14. The test used by the tax court regarding the degree of proof required for a party to successfully attack his agreement was that "when the parties to a transaction such as this one have specifically set out the covenants in the contract and have there given them an assigned value, *strong proof* must be adduced by them in order to overcome that declaration." Carl L. Danielson, 44 T.C. 549, 556 (1965). The first case to formulate this test was Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), *aff'g* 29 T.C. 129 (1957).

15. The early decisions set the precedent, *e.g.*, Cox v. Helvering, 71 F.2d 987 (D.C. Cir. 1934); Christensen Mach. Co., 18 B.T.A. 256 (1929); Black River Sand Corp., 18 B.T.A. 490 (1929), and have been consistently followed; *see, e.g.*, Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954); Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959). For a

has surrendered his right to earn income from a particular form of service. The consideration received is deemed the equivalent of compensation for the affirmative act of rendering the personal service.[16]

The vendee, on the other hand, obtains a depreciation deduction through amortization of the cost of the covenant over its useful life.[17] The theory permitting amortization is that the buyer has purchased a valuable capital asset in the form of freedom from competition for the term of the covenant. Since the covenant is worthless upon expiration of the period, its cost is a capital expenditure and subject to a depreciation allowance.[18]

When the covenants accompany the sale of a business, however, the transfer of goodwill[19] is also relevant.[20] Ordinarily, an excess of purchase price over the value of all tangible and identifiable intangible assets is attributed either to goodwill or the covenant. If the excess is ascribed to goodwill and not the covenant, the vendor receives favorable capital gains treatment, for goodwill is

---

general discussion of the treatment of payments received for covenants not to compete as ordinary income see 3B MERTENS, FEDERAL INCOME TAXATION § 22.33 (rev. ed. 1966).

16. *See* Beal's Estate, 82 F.2d 268 (2d Cir. 1936); Salvage v. Commissioner, 76 F.2d 112 (2d Cir. 1935), *aff'd*, 297 U.S. 106 (1936); 3B MERTENS, FEDERAL INCOME TAXATION § 22.33 (rev. ed. 1966).

17. *See, e.g.*, Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959); Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954). In order to depreciate the cost over the term of the covenant, the elimination of competition must be for a definite and limited term. *See* Clark Thread Co., 28 B.T.A. 1128 (1933), *aff'd*, 100 F.2d 257 (3d Cir. 1938); 4 MERTENS, FEDERAL INCOME TAXATION § 23.68 (rev. ed. 1966).

18. *See* Farmers Feed Co., 17 B.T.A. 507, 551-54 (1917); 4 MERTENS, FEDERAL INCOME TAXATION § 23.68 (rev. ed. 1966).

19. For discussion of the concept of goodwill see McDonald, *Goodwill and the Federal Income Tax*, 45 VA. L. REV. 645 (1959); Note, *An Inquiry into the Nature of Goodwill*, 53 COLUM. L. REV. 660, 664-65 (1953). A well-known definition of goodwill was offered by Justice Story:

> Goodwill may be properly enough described to be the advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.

STORY, PARTNERSHIPS § 99, at 158 (5th ed. 1859).

20. The goodwill factor is relevant whether the business is transferred by a sale of assets or a sale of stock. In a sale of assets, the assets, goodwill and covenant not to compete are independent items. In a sale of stock, the stock and covenant are distinct factors, but the assets and goodwill combined determine the value of the stock. In either type of transfer the amount by which the purchase price exceeds the stated value of the assets, to the extent that it is not allocated to the covenant, will be allocated to goodwill. Thus the determination of the dollar value of the covenant involves the same considerations in either situation.

a capital asset.[21] Since it is considered a capital asset with an indeterminable life, however, the buyer is not permitted to amortize its cost.[22]

The interests of the vendor and vendee are antithetical in negotiating the amount to be allocated between the covenant not to compete and goodwill. The vendor, preferring capital gains to ordinary income, will seek a greater allocation to goodwill and a lower allocation to the covenant. The vendee will seek total allocation to the covenant, which has a limited life and furnishes depreciation deductions.

JUDICIAL TESTS FOR THE EXISTENCE AND VALUE OF THE COVENANT

The foregoing principles governing the tax treatment of covenants not to compete and goodwill are simple and well settled. The source of the confusion and litigation is the basically factual question whether the covenant has an ascertainable value independent from the goodwill transferred with the business and the dollar amount of that value. The vagueness of prior standards used by the courts to make this determination has resulted in conflicting decisions and yielded total unpredictability.

Three major tests have been formulated to determine whether the covenant has independent value: whether the covenant can be segregated from goodwill; whether a genuine covenant exists; and whether the covenant has any independent significance. Older cases attempted to resolve the issue on the relation between the covenant and goodwill and classified the covenant as either "severable" or "nonseverable" from the goodwill transferred.[23] If the covenant was not treated separately in respect to cost and value, it was considered "nonseverable" and only a contributing element of the assets transferred.[24] On the other hand, if the agreement could be segregated, assuring that a separate item had been sold, the covenant was "severable" and assigned an independent value.[25]

The second standard, originally adopted by the Ninth Circuit in *Schulz v. Commissioner*,[26] said the applicable test is that the "covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men,

21. *See* Rodney B. Horton, 13 T.C. 143, 149 (1949); Aaron Michaels, 12 T.C. 17, 19 (1949).

22. Treas. Reg. § 1.167(a)-3 (1956), *as amended*, T.D. 6452, 1960-1 CUM. BULL. 127.

23. *See, e.g.*, Commissioner v. Gazette Tel. Co., 209 F.2d 926 (10th Cir. 1954), *aff'g* 19 T.C. 692 (1953); Aaron Michaels, 12 T.C. 17 (1949); Toledo Blade Co., 11 T.C. 1079 (1949), *aff'd*, 180 F.2d 357 (6th Cir. 1950); Toledo Newspaper Co., 2 T.C. 794 (1943).

24. The result was capital gains treatment for the vendor and a non-depreciable item for the vendee. *See* cases cited note 23 *supra*.

25. The amount assigned to the covenant was ordinary income to the vendor and amortizable by the vendee. *See* cases cited note 23 *supra*.

26. 294 F.2d 52 (9th Cir. 1961).

genuinely concerned with their economic future, might bargain for such an agreement."[27] This approach considers the pertinent issue to be the factual question whether a genuine covenant exists. The rationale is that since a covenant which has a basis in economic reality must contribute to goodwill, the determination whether the covenant is "severable" or "nonseverable" is of no probative value.[28]

A majority of courts have rephrased the "severability" tests in formulating the present generally accepted test: whether "the covenant is so closely related to a sale of goodwill that it fails to have any independent significance apart from merely assuring the effective transfer of that goodwill."[29] Although this test of independent significance and the test adopted in *Schulz* both present some measurable standard, the problem of separating the goodwill from the covenant on a dollar basis remains after the determination that the covenant has value.

Whichever test was used to determine the factual issue of the covenant's value, the degree of proof required of taxpayers challenging their agreements was settled. As stated in *Ullman v. Commissioner*,[30] if the parties "have specifically set out the covenants in the contract and have given them an assigned value, *strong proof* must be adduced by them in order to overcome that declaration."[31] When first adopted this test appeared to be a workable approach to the problem,[32] but the wide variety of factors considered in determining whether the "strong proof" requirement has been met has made it impossible to predict in a given case which factor or factors will be sufficient to overcome the stated value allocated to the covenant.

Before *Danielson*, then, a court was faced with one or more of the following difficult inquiries: (1) whether the covenant was "severable" from goodwill; (2) whether the covenant had an "ar-

---

27. *Id.* at 55.

28. For other cases applying this test *see, e.g.*, Barran v. Commissioner, 334 F.2d 58 (5th Cir. 1964); Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962). Aside from this practical matter, there is ample authority from the common law concerning covenants that an agreement not to compete must protect goodwill to some degree or else it is unenforceable. *See* Clark v. Needham, 125 Mich. 84, 83 N.W. 1027 (1900); Gamewell Fire Alarm Tel. Co., v. Crane, 160 Mass. 50, 35 N.E. 98 (1895). *See generally* CORBIN, CONTRACTS § 1387 (rev. ed. 1962).

29. Ullman v. Commissioner, 264 F.2d 305, 307 (2d Cir. 1959). For other cases applying this test *see, e.g.*, Levine v. Commissioner, 324 F.2d 298 (3d Cir. 1963); Dairy Services, Inc., 25 CCH Tax Ct. Mem. 605 (1966).

30. 264 F.2d 305 (2d Cir. 1959).

31. *Id.* at 308 (emphasis added).

32. The "strong proof" requirement announced in *Ullman* was the first clear statement of the degree of proof which must be produced by a party seeking to ignore an express allocation to a covenant and the first attempt to give predictability to the tax treatment of covenants not to compete.

guable relationship with business reality"; (3) whether the covenant had an "independent significance apart from goodwill"; and (4) having found a covenant to exist, what constituted a showing of "strong proof" to rebut its stated value. Conflicting decisions and needless uncertainty ensued, as evidenced by the varying factual elements given weight by the courts in determining the value of the covenant.[33]

33. *E.g.*, (1) *Awareness of tax consequences. Compare* Schulz v. Commissioner, 294 F.2d 52 (9th Cir. 1961) *and* Harry Schwartz, 19 CCH Tax Ct. Mem. 1276 (1960) (seller's unawareness of the unfavorable tax consequences involved in allocating an amount to a covenant not to compete was a ground for not holding him to his agreement), *with* Balthrope v. Commissioner, 356 F.2d 28 (5th Cir. 1966), Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954), Dairy Service, Inc., 25 CCH Tax Ct. Mem. 605 (1966) *and* Fulton Container Co., Inc., 64-2 U.S. Tax Cas. 93549 (S.D. Cal. 1965) (seller held to his agreement despite his unawareness of the tax consequences).

(2) *Absence of specific allocation. Compare* Estate of Masquelette, 239 F.2d 322 (5th Cir. 1956) *and* Andrew A. Monaghan, 40 T.C. 680 (1963) (absence of allocation a ground for capital gain treatment), *with* Rinehart Oil News Co., 24 CCH Tax Ct. Mem. 942 (1965) (despite failure to allocate, covenant was taxed as ordinary income) *and* Rodney B. Horton, 13 T.C. 143 (1949). *Compare* Rinehart Oil News Co., *supra*, (court would not disturb the intention of the parties not to allocate), *with* Wilson Athletic Goods Mfg. Co., 222 F.2d 355 (7th Cir. 1955) (parties' failure to allocate was disregarded and the court assigned a value to the covenant).

(3) *Presence of specific allocation. Compare* Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959) (presence of specific allocation a ground for taxing the proceeds as ordinary income) *and* Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954), *with* Toledo Newspaper Co., 2 T.C. 794 (1943) (despite a specific stated amount, the covenant was taxed as capital gains) *and* United Finance & Thrift Corp. v. Commissioner, 282 F.2d 919 (4th Cir. 1960) (despite a specific allocation, the court placed its own value on the covenant).

(4) *Whether the vendor is a shareholder, proprietor, or partner.* The courts have attempted to distinguish the sale of a proprietorship or partnership in which the vendor is said to have a direct relationship to the goodwill and therefore receives capital gain treatment, *see, e.g.*, Aaron Michaels, 12 T.C. 17 (1949), from the sale of stock by a shareholder who supposedly has no goodwill to transfer since it is an asset of the corporation, and whose covenant is therefore taxed as ordinary income, *see, e.g.*, Richard Ullman, 29 T.C. 129 (1957). Aside from the merit of this distinction (if the vendor-stockholder is in a position to compete, his covenant has as much value as that of the proprietor or partner who is in a position to compete), the cases have not been uniform in applying the distinction. *Compare* Richard Ullman, *supra*, (stockholder-vendor's covenant taxed as ordinary income), *with* George H. Payne, 22 T.C. 526 (1954) (stockholder-vendor accorded capital gains treatment).

(5) *Realistic allocation.* Although many cases have held that the covenant must have some arguable relationship with business reality, *e.g.*, Schulz v. Commissioner, 294 F.2d 52 (9th Cir. 1961), a number of recent decisions have not let an unreasonable allocation stand in the way of holding the vendor to his agreement, *see, e.g.*, Federal Oil Co., 25 CCH Tax Ct. Mem. 996 (1966); Benjamin Levinson, 45 T.C. 380 (1966); B. Lichtman, 23 CCH Tax Ct. Mem. 1745 (1964).

(6) *When the covenant is inserted as a tax benefit to the buyer. Compare* Harry Schwartz, 19 CCH Tax Ct. Mem. 1276 (1960) *and* George

The lack of a clearly defined standard for tax treatment of a covenant not to compete also caused considerable problems for both taxpayers and the Commissioner. The most notable difficulties were frequent nullifications of the reasonably predictable tax consequences of the agreement and the difficult burden placed on the Commissioner in attempting to make a proper apportionment between the covenant and goodwill. Because of these difficulties and the conflicting tax consequences to the vendor and vendee, courts have recently placed increasingly greater weight upon the contractual allocations agreed to by the parties themselves.[34]

COMPARISON OF DANIELSON WITH RECENT CASES

Since the tax court in *Danielson* made a specific finding that the taxpayers sustained the burden of "strong proof," and since this degree of proof failed to satisfy the new test, it would appear that the Third Circuit has adopted a totally new rule of law. A sufficient showing of strong proof has been made in very few cases and no court has held the taxpayer to his agreement when the burden was met. Closer analysis, however, reveals that the *Danielson* rule is new in name only. It is a logical development and not a complete break with prior law.

First, several cases decided under the strong proof rule contained facts and holdings which substantially support the rule espoused in *Danielson.*[35] For example, in *Balthrope v. Commissioner,*[36] taxpayers attempting to meet the strong proof require-

---

H. Payne, 22 T.C. 526 (1954) (that the covenant was injected by the vendee to obtain a tax advantage was a ground for not holding the vendor to his agreement), *with* Balthrope v. Commissioner, 356 F.2d 28 (5th Cir. 1966), Rogers v. United States, 290 F.2d 501 (9th Cir. 1961) *and* Jack Zeigelheim, 26 CCH Tax Ct. Mem. 431 (1967) (amount allocated to the covenant upheld despite a tax avoidance scheme on the part of the purchaser).

(7) *Conditon of the covenantor.* Although age, health, previous activity and future plans of the covenantor have been considered by the courts in attempting to ascertain the value of a covenant, it is difficult to determine from the cases how much weight has been given to such factors. *Compare* Max J. Epstein, 23 CCH Tax Ct. Mem. 1167 (1964) (vendor successfully attacked the covenant by showing that he was 74 years old, ill, and had no intention of competing with the vendee), *with* Balthrope v. Commissioner, 356 F.2d 28 (5th Cir. 1966) (that the vendor told the vendee that he was sick and would never compete with him held to be of no consequence).

34. *See, e.g.,* Balthrope v. Commissioner, 356 F.2d 28 (5th Cir. 1966); Montesi v. Commissioner, 340 F.2d 97 (6th Cir. 1965); Rogers v. United States, 290 F.2d 501 (9th Cir. 1961); Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959); Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954); Benjamin Levinson, 45 T.C. 380 (1966); B. Lichtman, 23 CCH Tax Ct. Mem. 1745 (1964).

35. *See, e.g.,* Balthrope v. Commissioner, 356 F.2d 28 (5th Cir. 1966); Benjamin Levinson, 45 T.C. 380 (1966); Dairy Service, Inc., 25 CCH Tax Ct. Mem. 605 (1966); B. Lichtman, 23 CCH Tax Ct. Mem. 1745 (1964).

36. 356 F.2d 28 (5th Cir. 1966).

ment presented facts far more convincing than the facts in *Danielson*. The vendor told the vendee that he was ill and could never compete with him. The buyer prepared the agreements and was in control of the negotiations. The covenant not to compete was discussed for only five minutes and the vendor, not represented by counsel, was completely unaware of the unfavorable tax consequences. The vendor was clearly responsible for the goodwill of the business and the total consideration was not in excess of the book value of the assets transferred. These facts, as the dissent in *Balthrope* noted,[37] should have been sufficient to meet the strong proof test. Both *Danielson* and *Balthrope* held the vendor to his agreement, but under different rules. The *Balthrope* court, therefore, would apparently sustain the taxpayer's attack on the agreement only by a showing of fraud, duress or undue influence. The only difference between the two cases is that the *Balthrope* court did not announce the rule which in substance it was applying.

The result reached in *Danielson* is also similar to recent cases upholding covenants in the face of unrealistic allocations while still purporting to apply the strong proof rule. In *Benjamin Levinson*,[38] for example, the court said:

> While we believe that a somewhat more realistic allocation of the purchase price might have been made, and recognize that the purchasers were acutely aware of the tax advantages of the allocation made in the agreement, nevertheless we are convinced that the agreement was made freely, willingly, and knowingly between two parties dealing at arm's length and we are not inclined to reform their agreement for them, which it seems unlikely [the vendor] could unilaterally do on his own behalf, for tax purposes.[39]

To the same effect is *B. Lichtman*,[40] where, after finding that the vendors did not enter into the agreement as a result of mistake, fraud, duress or misrepresentation, the court stated:

> Regardless of the [un]reasonableness of the allocation of the purchase price between the covenant not to compete and the other assets, it is evident that our acceptance of petitioner's present objections would require us to disregard the existing agreement. . . . We are not inclined to ignore the contract and create a new one. . . .[41]

In light of these decisions, the language in *Danielson* holding the parties to their agreement even though the evidence "would support a finding that the explicit allocation had no independent basis in fact or arguable relationship with business reality"[42] is not with-

37. *Id.* at 35 (dissenting opinion).
38. 45 T.C. 380 (1966).
39. *Id* at 389
40. 23 CCH Tax Ct. Mem. 1745 (1964).
41. *Id.* at 1747.
42. Commissioner v. Danielson, 378 F.2d 771, 777 (3d Cir. 1967).

out support.

A third element placing *Danielson* in proximity to cases applying the strong proof rule is the recent emphasis on the intent of the parties. In earlier cases the questions of "severability" and "economic reality" were the relevant inquiries and the parties' intent was not given much weight. In *Annabelle Candy Co. v. Commissioner*[43] and *Rinehart Oil News Co.*,[44] however, the courts held that although the covenant played a substantial part in the negotiations and would have been a valuable benefit to the vendee, if the parties did not intend to allocate a part of the purchase price to the covenant, their intent must be respected.[45]

Cases sustaining an allocation despite a lack of real bargaining for the covenant also support *Danielson* in substance. Following the decision of the Tenth Circuit in *Hamlin's Trust v. Commissioner*,[46] these cases held that brief negotiation and unawareness of tax consequences, factors usually indicative of a lack of realistic bargaining, do not prevent the court from upholding an agreement.[47] As stated in *Hamlin's Trust*:

> It is reasonably clear that the sellers failed to give consideration to the tax consequences of the provision, but where parties enter into an agreement with a clear understanding of its substance and content, they cannot be heard to say later that they overlooked possible tax consequences. . . . Having thus agreed, the taxpayers are not at liberty to say that such was not the substance and reality of the transaction.[48]

That *Danielson* held the vendors to their agreement because they understood what they were signing, despite a lack of extensive negotiations and their unawareness of tax consequences, is therefore not a complete departure from prior decisions.

Perhaps the strongest support for the *Danielson* rule comes from those cases which have held parties to their agreement mainly because a stated consideration was specifically allocated to the covenant. As noted in *Barran v. Commissioner*:[49]

> The courts that have contributed to the jurisprudence in this field seem to hold that where the parties bargain at arm's length over the terminology to be used in expressing

---

43. 314 F.2d 1 (9th Cir. 1962).

44. 24 CCH Tax Ct. Mem. 942 (1965), *aff'd per curiam*, 369 F.2d 692 (5th Cir. 1966).

45. In both cases there was no allocation to the covenant and the vendees attempted to amortize an amount they felt the covenant was worth. In both the burden of strong proof was held to apply to vendees as well as vendors.

46. 209 F.2d 761 (10th Cir. 1954).

47. *See* Dairy Service, Inc., 25 CCH Tax Ct. Mem. 605 (1966); Fulton Container Co., 64-2 U.S. Tax Cas. 93549 (S.D. Cal. 1964).

48. 209 F.2d at 765.

49. 334 F.2d 58 (5th Cir. 1964).

> an agreement not to compete and conclude with a specific agreement including a separately stated consideration not to compete, this amounts to something like a bargain between them that the seller, covenantor, will assume the unfavorable tax consequences flowing from the receipt of the consideration and the purchaser will get the corresponding tax benefits. . . .[50]

These cases upholding the valuation of a covenant because it was freely entered into, regardless of the economic reality of the situation,[51] are tantamount to the rule of *Danielson* requiring proof of fraud, duress or undue influence. Indeed *Rogers v. United States*,[52] decided under the strong proof rule, noted that "third parties may question the resolutions of parties to a contract, but in the absence of fraud it is not ordinarily open to the bargainers to do so."[53] *Rogers* held that although the taxpayers had probably been maneuvered by the vendees into a tax disadvantage, since they agreed in writing to a specific allocation to the covenant, the court could refuse to look behind the agreement and properly sustain the allocation on its face.

Examination of these decisions leads to one of two conclusions. Either these recent cases have been applying a *Danielson* type of rule while purporting to apply the strong proof rule, or, as the Third Circuit believed, the strong proof rule requires that a taxpayer be held to his agreement unless there is a showing of fraud, duress or undue influence.[54] From either point of view, the *Danielson* court was on firm ground in stating that prior case law reflected in substance the principle which they espoused.

The dissent described the rule adopted by the majority as an arbitrary one with no judicial precedent.[55] Granted that in no case relied on by the majority which held parties to their agreement was there a finding that the taxpayer had sustained his burden of strong proof. In *Danielson*, however, the court was confronted with that very situation because of their acceptance of the factual findings of the tax court. As previously noted, however, most of these cases involve analogous fact situations which yield similar results through the application of standards which differ in name only.

The dissent argued that the new rule completely disregarded Supreme Court decisions requiring questions of taxation to be de-

50. *Id.* at 58 n.2. The court said they did not have to go this far to agree that there is a heavy burden on the taxpayer disputing the allocation.
51. *See, e.g.*, Benjamin Levinson, 45 T.C. 380 (1966).
52. 290 F.2d 501 (9th Cir. 1961).
53. *Id.*
54. The *Danielson* court felt the strong proof rule required a showing of fraud, duress or undue influence, but nevertheless adopted the new rule in the event their belief was unwarranted. 378 F.2d at 777.
55. 378 F.2d at 779 (dissenting opinion).

cided according to truth and substance without regard to form.[56] Their reasoning is inapplicable, however; in looking only to general principles,[57] the dissent failed to acknowledge that the peculiar characteristics[58] of the covenant transaction have created the aforementioned difficulties for courts required to determine the existence or value of a disputed non-competition agreement. Accordingly, the dissenters could not appreciate the desirability of a rule which would give more credence to the form of the agreement selected by the parties.

CONSEQUENCES OF THE DANIELSON RULE

Although the *Danielson* rule is a statement of the kind of proof which must be adduced in a court proceeding to enable a taxpayer to successfully attack the stated consideration allocated to his covenant not to compete, the consequences of the rule will extend far beyond the courtroom.

The new rule will first logically affect the vendor and vendee in negotiating the amount to be allocated to a covenant not to compete. Because of the predictability the rule gives to the tax treatment of covenants, parties will be able to confidently structure their sales contracts to achieve the desired tax results. Since the desires of the vendor and vendee are antithetical, the presumed tax consequences have a real bearing on the total purchase price. Before *Danielson* the vendor could agree to a high allocation to the covenant and then attack the agreement as not reflecting

56. The dissent, although not grounding their opinion on this basis, also argued that parol evidence is always admissible to show that the true consideration for the agreement was other than that recited in the written contract. Consequently, they did not believe that the parol evidence rule was applicable to these cases. 378 F.2d at 782 n.3. The majority, on the other hand, felt the parol evidence rule would apply in this situation and that it would restrict the type of evidence the attacking party might adduce. Even if the rule was not a bar, the majority construed all the evidence adduced in this case as insufficient to show that the contract was not the parties' conscious agreement. 378 F.2d at 779.

57. None of the cases relied on by the dissent involved covenants not to compete, but were old and easily distinguishable cases cited only for general principles. *E.g.*, Gregory v. Helvering, 293 U.S. 465 (1935) (Commissioner attacked the form of a corporate reorganization as being without substance); Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939) (taxpayer disallowed depreciation on three buildings; court said although written form of agreement was a transfer of ownership with a lease-back, it was actually a loan secured by the property involved); Bartels v. Birmingham, 322 U.S. 126 (1947) (action to recover taxes paid under Social Security Act; question whether band members were employees of owner of business establishment, as stated in contract, or were actually employees of the bandleader); Landa v. Commissioner, 206 F.2d 431 (D.C. Cir. 1953) (question whether the consideration for certain payments made by a husband arose out of the marital relationship or were made to discharge his obligation for alimony).

58. The tax consequences of this type of transaction flow from its economic nature. *See* notes 15-18 *supra*.

the economic reality of the transaction,[59] thereby also gaining a tax advantage in the form of capital gains treatment. The effect was to grant a unilateral reformation of the agreement with a resulting unjust enrichment.[60] The vendee, since he would not be allowed to amortize, would lose a tax advantage for which he had given extra consideration. Since the tax saving was so unlikely to materialize, vendees were discouraged from paying extra consideration for the covenant.

Under *Danielson*, the vendor must decide whether he wants a low allocation to the covenant with a correspondingly higher proportion of capital gains treatment, or a high allocation and possibly greater consideration with ordinary income treatment for the price of the covenant. The vendee, on the other hand, will be willing to increase his price because of the certainty of obtaining a tax benefit in the form of amortization. Prior to *Danielson*, vendors were encouraged to unjustifiably risk litigation in order to obtain the benefits of their agreement as well as favorable tax treatment of it. The vendee often found himself forced to defend the agreement in order to amortize the amount allocated to the covenant.[61]

The dissent viewed the new rule as opening the door for individuals to avoid unfavorable tax consequences by artificial agreements: "[T]he difficult burden of showing fraud . . . placed upon the parties by the majority virtually insures that knowledgeable buyers will engage in questionable and sharp dealing to secure the advantages of such covenants, and the majority's rule will shield their agreements."[62] This view, however, ignores a major beneficial purpose of the new rule: to delimit how far a party may go in negotiating the price for the covenant. It permits shrewd dealing and hard bargaining, but draws the line at fraud, duress

59. This is how most of the litigation in this area arises, but cases also arise in which the vendee is seeking to amortize a certain amount when there has been no allocation to the covenant. *See, e.g.*, Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962); Rinehart Oil News Co., 24 CCH Tax Ct. Mem. 942 (1965).

60. The following hypothetical illustrates the point. Assume the assets of a business are worth $80,000. The vendee offers to pay the vendor $100,000 if $30,000 of the purchase price can be allocated to a covenant not to compete. The original cost to the vendee is greater, but he receives a benefit by being able to amortize $30,000. The increased purchase price is a benefit to the vendor, but this is qualified by the fact that it is ordinary income to him. If the vendor is allowed to successfully attack the allocation, he receives the extra consideration and also the benefit of having it taxed as capital gains. On the other hand, the vendee is forced to pay the increased amount while losing his amortization benefit.

61. For an interesting case holding the vendee liable for attorney's fees incurred by the vendor in successfully contesting the deficiency asserted against it because of the vendee's allocation, see Stern & Co. v. State Loan & Fin. Corp., 238 F. Supp. 901 (D. Del. 1965).

62. 378 F.2d at 782 (dissenting opinion).

and undue influence. The rule is designed to protect valid contracts and not, as the dissent viewed it, to shield sham agreements. That one party is more fully aware of the ramifications of the transaction than the other is no reason to permit the other to attack the agreement.[63] Unilateral reformation of a valid agreement should not be permitted merely because of its unfavorable consequences.

Danielson is also of major consequence to the Commissioner, since it greatly facilitates the tax collection process. Previously when a vendor ignored the contractual allocation and reported the total purchase price as capital gains, and the vendee relied upon the allocation and claimed depreciation deductions, the Commissioner was forced to challenge at least one of the positions to resolve the inconsistency. He would often be forced to take inconsistent positions and face litigation against both parties.[64] Under *Danielson*, the Commissioner can more readily accept taxpayers' agreements at face value with the knowledge that allocations can only be overthrown by a showing of fraud, duress or undue influence.

Furthermore, tax revenue will not be significantly impaired by allocations which may not reflect true values.[65] Excessive depreciation deductions produced by undue allocation to the covenant are balanced by the increased amount of ordinary income received by the vendor. Conversely, an understated allocation to the covenant, though increasing the proportion of capital gains for the vendor, reduces depreciation deductions available to the vendee. The reason for looking to substance over form in questions of taxation is to prevent frustration of the operation of the tax laws by forced adherence to the form chosen by the parties to reflect their transaction. Because of the aforementioned balancing factors, however, the allocations in a non-competition agreement cannot result in a loss of revenue or otherwise contravene the tax laws.[66]

CONCLUSION

The *Danielson* rule makes prior unsatisfactory standards obsolete and eliminates the many difficult, if not impossible, factual inquiries which previously plagued the courts. All are superseded by the clear statement that a party wishing to challenge the amount specifically allocated to a covenant not to compete must

63. *See* Rogers v. United States, 290 F.2d 501 (9th Cir. 1961).

64. Not knowing which party treated the covenant properly, the Commissioner would have to join both in the same action or risk the possibility of two separate lawsuits.

65. Impairment of tax revenue could only occur through careful planning by parties in significantly different tax brackets.

66. For another analysis of the *Danielson* rule see Comment, *The Danielson Rule on the Tax Consequences of a Covenant Not to Compete,* 116 U. PA. L. REV. 517 (1968).

show that fraud, duress or undue influence existed at the time the agreement was signed. The benefits of *Danielson* are the predictable tax consequences it provides for parties contemplating a non-competition agreement and the clear standard it furnishes to aid courts in resolving a disputed allocation. It is submitted that the *Danielson* rule should be adopted by the other courts of appeals to assure uniform tax treatment of covenants not to compete.

L. FREDERICK NEFF