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ACCOUNTING

## Tax Court in *Becker* Relies on *Danielson* Rule in Allocating Entire Purchase Price to Stock

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*An after-the-fact allocation by the buyer of part of the purchase price for stock to a covenant by the seller not to compete did not achieve the desired tax consequences. The case serves as a useful reminder that the parties should negotiate such allocations and memorialize those negotiations.*

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The Tax Court's decision in *Becker*, TC Memo 2006-264, RIA TC Memo ¶2006-264 , highlights the truism that what a contract says (and does not say) is critical in determining the proper allocation of the purchase price in a stock or asset sale.

In *Becker*, the purchaser argued strenuously that (1) a noncompete covenant had substantial value and (2) some amount should be allocated to the covenant since the contract was ambiguous as to an allocation to the covenant. Relying on the *Danielson* rule, however, the court ruled that none of the purchase price should be allocated to the noncompete covenant since the language in the contract clearly specified that the entire purchase price was for the stock. Accordingly, nothing was left over to allocate to the noncompete covenant.

As an alternative legal basis, the Tax Court also found that the parties did not mutually intend to allocate any consideration to the noncompete covenant since none of the parties even discussed a possible allocation of the purchase price to the covenant prior to the closing.

## FACTS

Becker Holding Corporation (BHC) was a family-owned corporation engaged in various aspects of the citrus industry, including planting and growing citrus trees, caretaking of groves, harvesting fruit, and processing and selling citrus juice, concentrate, and fruit. During 1990 and early 1991, a dispute arose among family members regarding future control and management of BHC. As a result of this dispute, BHC terminated the employment of William Becker, its chief operating officer and one of its principal shareholders, in February 1991. William was very prominent in the citrus industry and had previously served as chairman of the Florida Citrus Commission for five years.

Over the next three weeks, negotiations took place among BHC, BHC's attorney, and William for the redemption of William's stock in BHC. BHC's attorney drafted an agreement providing for the redemption of all of William Becker's stock. Section 1 of the agreement clearly stated that BHC would purchase William's stock for \$23.9 million payable over a five-year period, and contained a specific breakdown of the installment payments between principal and interest.

The redemption agreement also contained a limited noncompete covenant, which provided that William was free to engage in all aspects of the citrus industry, except that for a three-year period he was not allowed to engage in the processing or sale of citrus concentrate or juices. The redemption agreement did not include any allocation of the purchase price to the noncompete covenant. William hired his own counsel to review the agreement, who advised him to sign it without any changes.

At closing on 4/1/91, BHC paid \$5 million to William and executed a promissory note for the unpaid balance of the purchase price (approximately \$18.9 million). The promissory note provided for a 10% interest rate on the unpaid balance.<sup>1</sup> The note also contained an offset provision, which provided that BHC had the right to offset, defer, or suspend payments due under the promissory note if William breached the noncompete covenant. In order to secure payment of the unpaid purchase price, BHC and William entered into a pledge-and-escrow agreement granting William a security interest in the shares being redeemed. The recital clause in the pledge-and-escrow agreement reiterated that the purchase price for William's stock was \$23.9 million.

About eight months after the closing, William's accountant informed him that BHC had missed a tax-advantaged opportunity by not allocating any portion of the purchase price to the noncompete covenant.<sup>2</sup> In February 1992, William's accountant met with BHC representatives to discuss redrafting the purchase documents to provide for an allocation to the noncompete covenant in exchange for BHC paying additional consideration to William or reducing the noncompete period. These discussions were terminated, however, due to a new conflict between the parties and no agreement was reached.

In March 1992, BHC sued William, claiming that he had materially breached the noncompete covenant. As a result, BHC refused to pay the \$5 million installment due on 4/1/92. William counterclaimed for the accelerated payment of the amounts owed to him under the promissory note. In March 1994, a federal district court ruled that William had not breached the noncompete covenant, and held for him on his claim for full payment under the promissory note. BHC appealed and in March 1996 the Eleventh Circuit affirmed the district court's judgment in William's favor. On 5/22/96, BHC paid approximately \$27 million to William Becker in satisfaction of the entire judgment.

On his tax returns, William reported all of the sales proceeds as being allocated to the stock, which was subject to the then applicable long-term capital gains rate of 28% (as

compared with the maximum ordinary income tax rate of 39.6% in 1996 if any amount had been allocated to the noncompete covenant). In contrast, BHC allocated \$6.3 million of the purchase price to the noncompete covenant. BHC based this amount solely on an expert valuation of the covenant obtained approximately 15 months after closing.<sup>3</sup>

To avoid being "whipsawed" by the divergent tax treatment of the same transaction, the IRS issued a notice of deficiency to both parties disagreeing with each party's characterization of the transaction. The Tax Court consolidated the cases for trial. While the IRS could have remained neutral during the litigation, the IRS asserted the *Danielson* rule and took the position in favor of William that all the proceeds should be allocated to the stock.

## THE TAX COURT'S OPINION

The Tax Court ruled that the entire purchase price should be allocated to the stock with no allocation to the noncompete covenant. In reaching its decision, the Tax Court analyzed applicable Eleventh Circuit precedent (since an appeal would lie to the Eleventh Circuit) and relied on two separate legal theories—the *Danielson* rule and the mutual intent test.

### ***Danielson* Rule Analysis**

The Eleventh Circuit has adopted the Third Circuit's holding in *Danielson*, 19 AFTR 2d 1356, 378 F2d 771 (CA-3, 1967), that if a contract unambiguously contains an express allocation of the purchase price, then that allocation will be respected unless the taxpayer challenging the express allocation proves the contract is unenforceable due to mistake, fraud, duress, or undue influence.<sup>4</sup> Accordingly, the Tax Court applied the *Danielson* rule in *Becker*.

BHC did not argue that the purchase documents were unenforceable due to mistake, fraud, duress, or undue influence. Rather, BHC argued that the *Danielson* rule did not apply because the purchase documents were ambiguous as to an allocation between the stock and noncompete covenant. The Tax Court, however, found that the purchase documents repeatedly reflected an unambiguous allocation of the entire \$23.9 million purchase price to William's stock. The redemption agreement contained the following language:

"price: Seller will sell and Buyer will *purchase Seller's entire common stock* of becker holding corporation consisting of 1,000 shares at \$1.00 par at and *for a purchase price of Twenty-three Million Nine Hundred Fifty-Three Thousand Nine Hundred Thirty-four Dollars (\$23,953,934.00)*, together with interest at the rate of 10% per annum on the unpaid balance...." (Emphasis added.)

Likewise, the court found that the pledge-and-escrow agreement corroborated the redemption agreement by stating that the purchase price for the stock was \$23,953,934. Furthermore, the language in the promissory note stated that the note was being issued in connection with the redemption of William's stock.

In an attempt to overcome the clear language of the purchase documents, BHC argued that the *Danielson* rule did not apply because no specific amount was mutually allocated to the covenant. The court noted that the purchase documents did not explicitly state that zero dollars were being allocated to the covenant. Nevertheless, the purchase documents repeatedly reflected the express allocation of the entire \$23.9 million

purchase price to the stock. The Tax Court found that, as a matter of simple arithmetic, no portion of the consideration was left over to allocate to the covenant not to compete. This type of allocation is referred to as an "implicit zero allocation," and this analysis has been adopted by several courts and the IRS.<sup>5</sup>

Relying on *Patterson*, 59 AFTR 2d 87-524, 810 F2d 562 (CA-6, 1987), BHC argued that the "in consideration" clauses in the redemption agreement and the pledge-and-escrow agreement caused the allocation to be ambiguous. In *Patterson*, the Sixth Circuit declined to apply the *Danielson* rule because the sales agreement did not contain an unambiguous allocation with respect to the purchase price based on the following language: "As consideration for part of the purchase price ... Patterson agrees, simultaneously with the execution of this agreement, to enter into a Covenant Not to Compete in the form attached hereto" (emphasis added). This clause expressly tied the covenant not to compete to part of the purchase price.

In contrast, the recital clause in the redemption agreement in *Becker* contained general boilerplate language: "[I]n consideration of the mutual promises and covenants hereinafter set forth, it is agreed by and between r. william becker as Seller and becker holding corporation as Buyer as follows..." The pledge-and-escrow agreement in *Becker* also contained similar language in its recital clause. The Tax Court found that the language in these recital clauses did not tie a portion of the purchase price to the noncompete covenant, and, consequently, ruled that the "in consideration" clauses did not create any ambiguity in the purchase documents.

## Mutual Intent Test

The Tax Court next analyzed the transaction under the mutual intent test as adopted in *Better Beverages, Inc.*, 46 AFTR 2d 80-5219, 619 F2d 424 (CA-5, 1980).<sup>6</sup> It found that the parties did not mutually intend to allocate consideration to the noncompete covenant.

All of the individuals involved in the transaction, including William and BHC's attorney, testified that there were no discussions whatsoever regarding an allocation of the purchase price to the noncompete covenant prior to the execution of the purchase documents. In fact, Richard Becker, William's father and BHC's chairman and controlling shareholder, testified "nor was there any discussion about allocation. You keep using that word allocation, that was never a thought in my mind or was never a consideration in the whole deal. It was an afterthought from an accountant's standpoint."

Accordingly, the court found that the testimony of the individuals involved in the transaction, coupled with the purchase documents' explicit allocation of 100% of the purchase price to William's stock, clearly demonstrated that there was no mutual intent to allocate a portion of the consideration to the noncompete covenant.

In reaching this finding, the Tax Court rejected several creative arguments made by BHC. First, BHC argued that the importance of the covenant to BHC was evidence of the parties' mutual intent. BHC claimed that it would not have entered into the transaction without a noncompete covenant since William was such a formidable force in the citrus industry. The Tax Court, however, found that the importance of the noncompete covenant did not demonstrate mutual intent to allocate consideration to the covenant. The court quoted from *Annabelle Candy Co.*, 10 AFTR 2d 5500, 314 F2d 1, 62-2 USTC ¶19707 (CA-9, 1963):

"It is true ... that the covenant not to compete played a very real part in the negotiation of a final contract between the parties, and was a valuable benefit to the petitioner. But *if*

*the parties did not intend that a part of the purchase price be allocated to this important and valuable covenant, that intention must be respected.*" (Emphasis by the Tax Court.)

Second, BHC argued that the \$18.9 million promissory note represented an economic allocation of the purchase price to the noncompete covenant based on the offset provision in the note. That provision allowed BHC to offset the amount owed to William by the actual damages caused to BHC in the event William violated the covenant. Based on this offset provision, BHC claimed that the entire \$18.9 million balance represented an allocation to the noncompete covenant. The Tax Court found that this argument was not an accurate interpretation of the promissory note. Furthermore, the offset provision did not reflect the parties' mutual intent to allocate some portion of the purchase price to the noncompete covenant.<sup>7</sup>

Third, BHC argued that the post-sale discussions regarding a possible allocation to the noncompete covenant demonstrated the parties' mutual intent. The Tax Court observed that these discussions took place at least six months after the transaction closed and found they did not reflect the mutual intent of the parties at the time the purchase documents were executed.<sup>8</sup>

BHC also cited *Peterson Machine Tool, Inc.*, 79 TC 72 (1982), *Jorgl*, TC Memo 2000-10, RIA TC Memo ¶2000-010, *aff'd per cur.* 88 AFTR 2d 2001-5182, 264 F3d 1145 (CA-11, 2001), and *Ansan Tool & Mfg. Co.*, TC Memo 1991-121, PH TCM ¶91121, in support of its argument that the parties mutually intended to allocate consideration to the covenant. The Tax Court found that *Peterson* and *Jorgl* were factually distinguishable, and that *Ansan Tool* applied the Seventh Circuit legal standard, which differed from the Eleventh Circuit standard applicable in *Becker*.

In *Peterson*, the contract stated that the lump-sum purchase price was for *both* the stock and noncompete covenant, and the contract provided that the covenant was for a material portion of the purchase price. *Peterson* found, based on the language in the contract, that the parties intended to allocate some value to the covenant, but the contract was ambiguous since it did not contain any specific allocation between the stock and covenant. By contrast, the purchase documents in *Becker* allocated the entire purchase price to the stock. In *Jorgl*, the agreement explicitly provided that \$300,000 of the total \$650,000 purchase price was being paid for the covenant.

Accordingly, in both *Peterson* and *Jorgl* the purchase contract was evidence of the parties' intention to allocate some portion of the purchase price to the noncompete covenant. In contrast, the purchase documents in *Becker* not only did not allocate any part of the purchase price to the noncompete covenant but unambiguously allocated the entire purchase price to the stock. Accordingly, the Tax Court determined that *Peterson* and *Jorgl* were not applicable and did not support BHC's contention that there was mutual intent.

In *Ansan Tool*, the Tax Court had applied the Seventh Circuit standard that looks to all the evidence pertinent to the covenant to determine if it has independent value and, if it does, to determine how much the covenant is worth. The Tax Court in *Ansan Tool* found that the covenant had independent economic value, and thus that a portion of the consideration should be allocated to the covenant.<sup>9</sup> In contrast, the mutual intent test applicable in the Eleventh Circuit first focuses on whether the parties mutually intended at the time of sale that some portion of the purchase price be allocated to the seller's noncompete covenant. Under this standard, a court will examine the independent economic value of the covenant only if there is evidence of mutual intent. Accordingly, the Tax Court found *Ansan Tool* to have no bearing on its decision in *Becker*.

Unlike the cases cited by BHC, the Tax Court found the facts in *Becker* to be substantially similar to the facts in *Annabelle Candy* because (1) the transaction involved a stock sale and the agreement included a covenant not to compete, (2) there were no discussions about allocation of the price to the covenant prior to or at the time the agreement was signed, (3) the agreement did not allocate any portion of the price to the covenant, and (4) after the agreement was signed, one party made a unilateral allocation of a portion of the purchase price to the covenant. Like the Ninth Circuit in *Annabelle Candy*, the Tax Court in *Becker* concluded that the parties did not intend to allocate any portion of the purchase price to the noncompete covenant.

## ANALYSIS

The court's decision in *Becker* is not surprising, based on the applicable law and the overwhelming facts and testimony demonstrating that the parties, at the time of sale, did not intend to make any allocation to the covenant. This case involves the classic attempt by a buyer to make a unilateral allocation to a noncompete covenant after closing in an attempt to secure a valuable tax benefit, i.e., BHC never communicated (or even raised the issue) with the seller before the sale that it was planning to allocate any consideration to the covenant and BHC did not even obtain an appraisal valuing the covenant until more than a year after the transaction closed.

Moreover, during the course of this tax controversy, BHC lost all credibility with the Tax Court by (1) amending its petition once (and attempting to amend its petition a second time) to claim several different allocations to the covenant and (2) providing testimony from multiple experts at trial asserting numerous different valuations for the covenant.<sup>10</sup> BHC apparently was not happy with its original \$6.3 million allocation (based on an expert report rendered in 1992) and decided to "shoot for the moon" with new expert reports obtained in 2006 (including one report from the same appraiser who rendered the 1992 report) valuing the covenant between \$13.7 million and \$14.9 million. As a result, the Tax Court granted a preliminary motion filed by the IRS to exclude all the expert reports and testimony on the basis that such *post-sale* valuation reports had no bearing under the *Better Beverages* mutual intent test regarding the amount BHC actually paid for the covenant *at the time of closing*. Indeed, the most interesting aspect of *Becker* is why BHC went through all the time and expense of engaging numerous experts and litigating this matter.

Significantly, *Becker* is the first case in which the Tax Court applied the *Danielson* rule in the context of an "implicit zero allocation." The court relied on the "strong proof" rule in prior "implicit zero allocation" cases.<sup>11</sup> The court has not officially adopted the *Danielson* rule and will apply it only to cases that are appealable to a circuit that has adopted the *Danielson* rule.<sup>12</sup> Since this case is appealable to the Eleventh Circuit, which has adopted the *Danielson* rule, the court's application of the *Danielson* rule is the correct legal standard.

Also, *Becker* is unusual in that the parties previously litigated in federal district court and the Eleventh Circuit over whether the seller had breached the noncompete covenant. BHC argued that the noncompete covenant had significant value to BHC since (1) BHC viewed William Becker as a significant competitive threat in the citrus industry and (2) BHC had spent significant amounts of time and expense in the prior litigation in protecting its rights under the noncompete covenant. From a tax perspective, however, the importance or value of a noncompete covenant to a buyer and the right to tax benefits of a purchase price allocation to a noncompete covenant are two entirely separate issues. In *Better Beverages*, the Fifth Circuit ruled that evidence and allegations of value of the covenant to its buyer, not communicated to the seller during the negotiations or at the time of the

sale, simply cannot alone predict the countervailing value to the seller or answer the more fundamental question of how much the buyer paid for the covenant. *Becker* is very instructive on how to draft an enforceable allocation to a noncompete covenant and highlights the pitfalls when a party tries to make a unilateral allocation after the fact.

## CONCLUSION

The Tax Court relied on two different legal theories, i.e., the *Danielson* rule and the mutual intent test, to determine that none of the purchase price was allocable to the covenant not to compete. In *Becker*, the purchase documents contained an express allocation of the entire purchase price to the stock.

In order to have an enforceable allocation to a noncompete covenant, it is important that the language in a purchase contract contain an explicit and unambiguous allocation to that covenant. Moreover, if an allocation is intended, the parties should discuss and agree on an allocation prior to the closing and the purchase documents should clearly evidence this allocation. As shown by this case and many others, a court will not look favorably on a situation where one party overlooks the tax allocation issue prior to closing and then attempts to make a unilateral allocation afterwards. In *Becker*, all of the evidence demonstrated that BHC overlooked the tax allocation prior to closing and made a unilateral allocation on its tax return only after closing when it learned about the tax benefits associated with making such an allocation.

Purchase price allocations continue to have significant tax consequences under current law to (1) individual sellers, with the significant difference in ordinary and capital gains rates applicable to the sales proceeds, and (2) buyers, with the ability to amortize amounts allocated to a noncompete covenant over a 15-year period vs. no amortization for amounts allocated to stock. Accordingly, parties to any stock and asset transaction should discuss and agree on an allocation beforehand and clearly memorialize such allocation in the purchase documents.

## Practice Notes

To have an enforceable allocation to a noncompete covenant, it is important that the language in a purchase contract contain an explicit and unambiguous allocation to that covenant. *Becker* is very instructive on how to draft an enforceable allocation to a noncompete covenant and highlights the pitfalls when a party tries to make a unilateral allocation after the fact.

[1](#)

Based on the \$18.9 million balance and the 10% interest rate accruing under the promissory note, BHC was required to pay annual installments of \$5 million to William Becker for five years for a total payment of \$25 million pursuant to the note.

[2](#)

In accordance with then-applicable law, under Reg. 1.167(a)-3 BHC could have amortized any amount allocated to the noncompete covenant over its three-year life. In contrast, BHC could not amortize any amount allocated to the stock. Section 197, mandating a 15-year amortization period for amounts allocated to noncompete covenants, generally became effective for covenants acquired after 8/10/93. From William's perspective as seller, any amount allocated to the covenant would have been treated as ordinary income taxable at the slightly higher 31% tax rate in 1991, as compared to a 28% rate for long-term capital gains for amounts allocated to the stock.

[3](#)

Based on the \$6.3 million valuation, BHC deducted (1) \$1 million of the first \$5 million payment to William on its 1991 tax return and (2) the remaining balance of \$5.3 million on its 1996 tax return when it made the final payment to William.

[4](#)

Bradley, 53 AFTR 2d 84-1208, 730 F2d 718 (CA-11, 1984) (affirming a district court holding that payments received were interest income pursuant to a sale rather than an option to purchase because the contract called for interest payments). See also Thomas, 92 AFTR 2d 2003-5292 (CA-11, 2003) (affirming, inter alia, that the taxpayers were bound by the allocation to the covenant not to compete contained in a stock purchase agreement).

[5](#)

The "implicit zero allocation" concept provides that if a contract allocates the entire purchase price to items other than the noncompete covenant, then no amount of purchase price is allocated to the covenant (and is treated as a zero allocation to the covenant). See, e.g., Critz, TC Memo 1987-538, PH TCM ¶187538 ; Wallach, TC Memo 1982-502, PH TCM ¶182502 ; Major, 76 TC 239 (1981); G C Services Corp., 73 TC 406 (1979); Lazisky, 72 TC 495 (1979), *aff'd sub nom.* Magnolia Surf, Inc., 47 AFTR 2d 81-619, 636 F2d 11 (CA-1, 1980); Lane Bryant, Inc., 74 AFTR 2d 94-6329, 35 F3d 1570 (CA-F.C., 1994); Stokely-Van Camp, Inc., 70 AFTR 2d 92-5649, 974 F2d 1319 (CA-F.C., 1992); Theophelis, 55 AFTR 2d 85-521, 751 F2d 165 (CA-6, 1984). See also "1991 IRS Litigation Guideline Memorandum," 1991 WL 1168521.

[6](#)

Since this Fifth Circuit case was decided before 10/1/81, it is binding precedent in the Eleventh Circuit under *Bonner v. City of Prichard*, 661 F2d 1206 (CA-11, 1981).

[7](#)

Also, in other cases, the Tax Court has found that the fact that the promissory note bore interest was another factor indicating that the parties did not intend to make an allocation to the noncompete covenant. See, e.g., Patterson, TC Memo 1985-53, PH TCM ¶185053 . In *Sigman*, TC Memo 1972-256, PH TCM ¶172256 , the court noted "it seems improbable that [the buyer] would pay interest on an obligation it incurred for a continuing covenant."

[8](#)

Under *Better Beverages, Inc.*, 46 AFTR 2d 80-5219, 619 F2d 424 (CA-5, 1980), the buyer must prove that the parties mutually intended *at the time of sale* that some portion of the consideration be allocated to the seller's noncompete covenant.

[9](#)

Also, the language of the noncompete agreement in that case specifically stated that the seller was providing the noncompete covenant in consideration for the execution of the buy-sell agreement, which provided evidence of the parties' intent to allocate some consideration to that covenant.

[10](#)

In addition to the original \$6.3 million allocation claimed on its tax return, BHC asserted the following allocations during the course of this tax dispute: (1) a \$25 million allocation in its amended petition filed with the Tax Court (based on the claimed legal significance of the offset provision in the promissory note), (2) a \$14.9 million allocation based on another report from the same appraiser who originally valued the covenant at \$6.3 million in 1992, and (3) a \$13.7 million allocation based on a degradation analysis employed by another expert using a "Monte Carlo" simulation.

[11](#)

See, e.g., Critz, Wallach, Major, G C Services Corp., and Lazisky, all *supra* note 5.

[12](#)

See, e.g., Coleman, 87 TC 178 (1986), fn. 17; Thomas, TC Memo 2002-108, RIA TC Memo ¶12002-108 , fn. 6.