

RESTRUCTURING BUSINESS TRANSACTIONS FOR FEDERAL INCOME TAX PURPOSES

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INTRODUCTION

A common phenomenon in the federal income tax field is the "restructured transaction"—a business arrangement that is classified differently by the Internal Revenue Service and the courts than by the private parties who entered into it. For example, an owner of business equipment may agree to lease it for an extended period with an option to purchase, on terms virtually insuring that the lessee will exercise the option because the aggregate rent to be paid equals the value of the property (plus an allowance to reflect the fact that payments are to be made over a period of years) and the option price is minimal. If the transaction is treated as the implementing documents provide and the parties intend, the owner reports gain or loss only if and when the option is exercised, and can deduct depreciation on the property in the interim. Conversely, the lessee can deduct the rent as a business expense as paid or accrued, and can depreciate the property only on becoming its owner by exercising the option.

But if the lease is found by the IRS and courts to be the functional equivalent of a sale of the property, the tax results are quite different. Viewed as a vendor of the equipment, the "lessor" must compute gain or loss when the "lease" is executed, and the subsequently received "rent" must be divided between nontaxable principal payments and taxable interest.¹ The "lessee," for its part, becomes the owner of the property for tax purposes from the date of the lease, is entitled to an investment credit if the property qualifies

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1. See I.R.C. § 162(a)(3) (rental or other payments for continued use of property deductible if taxpayer is not taking title and has no equity).

For the imputation of interest when deferred payments do not provide for explicit interest, see I.R.C. § 483. For a summary of the principal tax consequences to the "lessor" and "lessee" if a purported lease is determined to be a sale, see Rev. Rul. 72-408, 1972-2 C.B. 86; for complications in allocating payments between principal and interest, see *Commissioner v. Wilshire Holding Corp.*, 288 F.2d 799 (9th Cir. 1961); *Wilshire Holding Corp. v. Commissioner*, 262 F.2d 51 (9th Cir. 1959); and *Commissioner v. Wilshire Holding Corp.*, 244 F.2d 904 (9th Cir. 1957) (reversing the decision of the Tax Court with respect to allocation in each instance).

for that allowance, can depreciate the property over its estimated useful life, and must divide the "rent" between nondeductible capital outlays and deductible interest.

It necessarily follows that questions about the proper classification of a business transaction can arise in connection with almost any tax allowance. An issue may lie dormant for years, but spring to life when a particularly alert taxpayer or revenue agent perceives that the events, if reclassified, would have a different set of tax consequences. Whenever the issue arises, however, the ingredients determining whether a transaction should be accepted at face value or restructured are usually the same.²

The restructuring of a transaction usually raises important threshold issues of a procedural nature. Can the IRS hold the parties to the label that they selected if it so desires, or can taxpayers take the initiative in repudiating their own formal representations?³ Does the parol evidence rule prohibit the IRS or a party from introducing evidence of negotiations or prior understandings between the parties that are not reflected in the final written agreement?⁴ If the IRS is successful in restructuring the transaction as to one taxpayer, must it act consistently vis-à-vis the other party or parties to the same arrangement?⁵ If consistency is desirable or mandatory, how can it be assured, given the decentralized judicial review that results from the concurrent existence of a single United States Tax Court, hundreds of district courts, and eleven courts of appeals?⁶ Like the basic issue of reclassification, these procedural issues can arise when any of dozens of tax allowances are at stake.

Finally, it must be acknowledged that "restructuring" is too grandiose a term for the judicial process described below, if it implies that the legal relationships between the parties to the transaction are changed by its altered tax aspects. In point of fact, of course, the parties continue to be bound by the contract as written, which determines where legal ownership resides, what payments must be made and when, and the parties' other nontax rights and duties—unless, as sometimes occurs, a parallel restructuring occurs under local law in determining, for example, the applicability of usury, recordation, or regulatory laws.⁷ For these reasons, the term "reclassification" is sometimes used to indicate that the transaction's

2. See, e.g., *Frank Lyon Co. v. United States*, 98 S. Ct. 1291 (1978) (refusing to restructure sale-leaseback transaction as mortgage).

3. See text accompanying notes 38-44 *infra*.

4. See text accompanying notes 29-37 *infra*.

5. See text accompanying notes 45-50 *infra*.

6. *Id.*

7. See generally *EQUIPMENT LEASING—LEVERAGED LEASING* (Fritch & Reisman eds., PLI, 1977) (discussing the numerous nontax ramifications of a restructured leveraged lease) [hereinafter cited as Fritch & Reisman].

tax consequences are different from those ordinarily suggested by its label. But if "restructuring" is too grandiose a term, "reclassification" may be too modest, since it may be understood as implying no more than a change of labels. As pointed out above, whether the transaction is "restructured," "reclassified," "recast," or "realigned," the result is a completely different set of tax results from those that the parties bargained for.

I. SALE VS. LEASE

Although most leases contemplate that the occupant will use the property for a limited period of time and then surrender possession to the owner, business taxpayers frequently enter into leases that include an option to the lessee to purchase the property or that vest ownership in the lessee when a specified number of periodic payments have been made. Commenting on such an agreement, the Tax Court has observed: "Cases like this, where payments at the time they are made have dual potentialities, i.e., they may turn out to be payments of purchase price or rent for the use of property, have always been difficult to catalogue for income tax purposes."⁸

In *Starr's Estate v. Commissioner*,⁹ the Court of Appeals for the Ninth Circuit attributed the popularity of borderline arrangements bearing the label "lease" to tax considerations:

Yesterday's equities in personal property seem to have become today's leases. This has been generated not a little by the circumstance that one who leases as a lessee usually has less trouble with the federal tax collector. At least taxpayers think so.

But the lease still can go too far and get one into tax trouble. While according to state law the instrument will probably be taken (with the consequent legal incidents) by the name the parties give it, the internal revenue service is not always bound and can often recast it according to what the service may consider the practical realities.¹⁰

If the lessee is required to pay more than the fair rental value of

8. *Chicago Stoker Corp. v. Commissioner*, 14 T.C. 441, 444 (1950) (payments held to be nondeductible installments of purchase price rather than deductible rent). See also *Kitchin v. Commissioner*, 353 F.2d 13 (4th Cir. 1965) (rejecting the alternative of holding the transaction open until the lessee either exercised the option to purchase the property or allowed it to expire).

For a general discussion and a review of the early cases, see Blumenthal and Harrison, *The Tax Treatment of the Lease With an Option to Purchase*, 32 TEX. L. REV. 839 (1954).

9. 274 F.2d 294 (9th Cir. 1959) (purported lease of automatic sprinkler system treated as sale).

10. *Id.* at 294-95. See also Rev. Rul. 57-371, 1957-2 C.B. 214. On occasion, however, taxpayers prefer to have a borderline transaction treated as a sale. See, e.g., *Meiselman v. Commissioner*, 300 F.2d 666 (4th Cir. 1962); *Robertson v. Commissioner*, 19 B.T.A. 534 (1930) (lease-option restructured as sale at taxpayer's instance, although lease-option form was chosen to avoid state redemption laws in favor of buyers in possession).

the property, and is compensated for this burden by a low option price, he will lose the benefit of the excess rental payments unless he exercises the option; for practical purposes, therefore, the excess rent builds up an equity in the property.¹¹ As a result, the lessee's economic position resembles that of a purchaser of property who makes a large downpayment and finances the balance with a nonrecourse mortgage. Like the purchaser's freedom to default on the mortgage, the lessee's freedom to let the option expire without exercise is illusory in view of the resulting loss of his potential equity. This analysis is, of course, based on a prediction of future behavior; if the value of the property should in actuality drop below the option price, the lessee will not exercise the option, but it is equally true that a purchaser-mortgagor will not pay off a nonrecourse mortgage if the value of the property drops below the balance due.

By contrast, if the rent reserved in a lease does not exceed the fair rental value of the property, any option that is vested in the lessee will usually require payment of the anticipated value of the property at exercise. In this situation, the rent paid by the lessee does not build up an equity, and, when the lease is executed, there is no reason to expect the lessee to exercise the option rather than to let it expire. Conversely, the lessor cannot expect to be better off if the lease option expires, permitting him to offer the property on the market, than if the lessee decides to exercise it. For these reasons, a lease of this type should be treated as such; the lessee becomes a purchaser only if and when the option is exercised.

In an extended ruling outlining the principal contractual arrangements that raise classification problems, the IRS summarized its view of the governing principles as follows:

4.01. Whatever interest is obtained by a lessee is acquired under the terms of the agreement itself. Whether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed. In ascertaining such intent no single test, or any special combination of tests, is absolutely determinative However, from the decisions cited . . . , it would appear that in the absence of compelling persuasive factors of contrary implication an intent warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement may in general be said to exist if, for example, one or more of the following conditions are present:

- (a) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee

11. See note 1 *supra*.

.....
 (b) The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make

(c) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title

(d) The agreed "rental" payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property

(e) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made

(f) Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest

4.02. The fact that the agreement makes no provision for the transfer of title or specifically precludes the transfer of title does not, of itself, prevent the contract from being held to be a sale of an equitable interest in the property.

4.03. Conditional sales of personal property are, in general, recordable under the various State recording acts if the vendor wishes to protect its lien against claims of creditors. However, the recording or failure to record such a sales contract is usually discretionary with the vendor and is not controlling insofar as the essential nature of the contract is concerned for Federal tax purposes.¹²

12. Rev. Rul. 55-540, 1955-2 C.B. 39, 41-42 (citations omitted). For illustrations of the principles enunciated by Rev. Rul. 55-540, see *M. & W. Gear Co. v. Commissioner*, 446 F.2d 841 (7th Cir. 1971) (combination of high "rent" and low option price, compared with value of property, supports Tax Court conclusion that purported lease with option to purchase was a sale); *Universal Drilling Co. v. United States*, 412 F. Supp. 1231 (E.D. La. 1976) (concluding that guidelines of Rev. Rul. 55-540 "are consistent with the jurisprudence" and that ship charter was lease rather than sale). See also Rev. Rul. 55-541, 1955-2 C.B. 19 (lease of office equipment requiring very high rental payments during first 3 years and low payments during subsequent 10 years for use of equipment with estimated useful life of 10-15 years, treated as sale); Rev. Rul. 55-542, 1955-2 C.B. 59 (similar arrangement, under which title will pass to lessee at end of rental period upon payment of then depreciated value of the equipment, treated as sale); Rev. Rul. 60-122, 1960-1 C.B. 56 (contrasting two "leases" of business equipment by reference to the relationship between the term of the contract and the anticipated useful life of the property).

In *Oesterreich v. Commissioner*, 226 F.2d 798 (9th Cir. 1955), a leading case decided in the same year Rev. Rul. 55-540 was promulgated, the court was concerned with the correlative tax results for both parties to a purported lease:

Looking at this transaction from a long range view we find that if the opinion of the Tax Court is affirmed, *Wilshire Holding Corporation*, at the expiration of the

After setting out these general principles, Revenue Ruling 55-540 goes on to apply them to the following recurring factual patterns:

4.04. Agreements are usually indicative of an intent to rent the equipment if the rental payments are at an hourly, daily, or weekly rate, or are based on production, use, mileage, or a similar measure and are not directly related to the normal purchase price, provided, if there is an option to purchase, that the price at which the equipment may be acquired reasonably approximates the anticipated fair market value on the option date

4.05. In the absence of compelling factors indicating a different intent it will be presumed that a conditional sales contract was intended if the total of the rental payments and any option price payable in addition thereto approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges

4.06. If the sum of the specified "rentals" over a relatively short part of the expected useful life of the equipment approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges on such amount, and the lessee may continue to use the equipment for an additional period or periods approximating its remaining estimated useful life for relatively nominal or token payments, it may be assumed that the parties have entered into a sale contract, even though a passage of title is not expressly provided in the agreement.¹³

Revenue Ruling 55-540 is more than 2 decades old and many cases have been decided since it was promulgated, but it remains a useful guide for planning purposes. Some courts have preferred to search for the "intent" of the parties rather than employ the economic test espoused by the IRS, but their objection seems confined to Rev. Rul. 55-540's arithmetic ratios, rather than to its list of relevant factors, which was distilled from prior case law rather than invented by an imaginative revenue agent.¹⁴ Moreover, although Rev.

"lease," will have acquired a very valuable piece of property for payments written off entirely as business expense while petitioner will have, in effect, sold a valuable piece of property without having been able to treat the proceeds as a long term capital gain. *Id.* at 803. On examination, the court concluded that the transaction was tantamount to a sale, and should be so treated for tax purposes. In a companion case, the court mandated consistent treatment for the purported lessor. *See Commissioner v. Wilshire Holding Corp.*, 244 F.2d 904 (9th Cir. 1957).

13. Rev. Rul. 55-540, 1955-2 C.B., at 42-43.

14. *See, e.g.*, *Cubic Corp. v. United States*, 34 A.F.T.R.2d 5895 (S.D. Cal. 1974), *aff'd per curiam*, 541 F.2d 829 (9th Cir. 1976) (taxpayer tried unsuccessfully to invoke Rev. Rul. 55-540, described by the court as entailing "a hindsight attempt to distill the intent of the parties by means of a narrow and restrictive test"); *Meiselman v. Commissioner*, 300 F.2d 666, 668 (4th Cir. 1962) (if facts show that a sale was "the real intent of the parties . . . then the transaction should be so categorized for tax purposes"). *See also Benton v. Commissioner*, 197 F.2d 745, 752 (5th Cir. 1952) (predating Rev. Rul. 55-540 "good faith intent" controlling, rather than objective economic test).

Rul. 55-540 focused on leases executed in the ordinary course of business between tax-conscious manufacturers or dealers and their customers, its criteria are also applied to amateurs engaged in a one-shot transaction.¹⁵

The cases and rulings involving the sale-lease distinction that are discussed above arose out of two-party transactions, in which an owner of business equipment made it available to a user in return for periodic payments. In effect, the owner (whether ultimately found to be a seller or a lessor) financed the transaction by agreeing to be compensated over a period of time rather than when the contract was executed. If the owner is unable or unwilling to provide the necessary financing, the parties may turn to a third party as a source of capital. If they employ a conventional sale by the manufacturer or dealer to the customer, coupled with a normal mortgage loan by a bank or financial institution to the customer, the transaction's classification for federal income tax purposes will almost always correspond to its formal trappings.

In recent years, however, three-party equipment leases have come to the fore as competitors of conventional mortgages, particularly when the user does not want to carry a mortgage debt on its balance sheet¹⁶ or is prevented from borrowing by agreements with prior creditors or when tax allowances associated with ownership of the property (*e.g.*, the investment credit and accelerated depreciation) will produce greater tax savings for the party financing the transaction than for the actual user of the equipment. In the typical arrangement, the manufacturer or dealer sells the equipment to a leasing company or limited partnership composed of individual investors, thereby terminating its connection with the transaction, save for its warranties and other contractual obligations under the manufacturing or sales agreement. The purchasing group pays part of the sales price with its own resources and borrows the balance from a financial institution, ordinarily without recourse, and then leases the property on a net basis to the ultimate user, whose payments over the life of the lease enable the lessor to service its obligations to the lender.¹⁷

15. Rev. Rul. 55-540 was issued to deal with "new and unique types of agreements concerning the use of and disposition of equipment," devised by lessors who are "primarily interested in disposing of [their] wares to customers." *But see* Universal Drilling Co. v. United States, 412 F. Supp. 1231 (E.D. La. 1976) (Rev. Rul. 55-540 criteria applied to charter of barge by owner).

16. Current accounting standards, however, may require the transaction to be reflected as a liability on the lessee-user's balance sheet. *See* Financial Accounting Standards Board, Statement No. 13, Accounting for Leases (1976).

17. For a more detailed description, see Fritch & Reisman, *supra* note 7. *See generally* Goldstein, *Equipment Leasing After the 1969 Act*, 29 N.Y.U. INST. FED. TAX. 1589 (1971); Lukens, *Tax Treatment of the Lease With Option to Purchase: Is Allocation the Answer?*, 11

So far as the underlying business bargain is concerned (as distinguished from its documentation and labels), such a "leveraged" or "financial" lease (so-called to distinguish it from an "operating" lease) resembles a sale financed by first and second mortgages. For tax purposes, however, the lessor must stay on the "lease" side of the lease/sale boundary in order to get the tax allowances that, with the agreement of the user, it expects to enjoy. As compensation for relinquishing these tax allowances to the lessor, the lessee obtains better financial terms than would be available if the transaction was financed by a conventional mortgage loan. In effect, the parties allocate the tax allowances inherent in ownership of the property to the party who will save the most by claiming them, and they then split the resulting tax savings between themselves. Since the pie will be largest if the tax allowances are shifted to individuals subject to the highest personal tax rate, it is not surprising that neurosurgeons and rock music stars become the owner-lessors of computers, jet airplanes, and other costly business equipment.

In a seminal case involving a three-party equipment leasing arrangement (which the IRS argued was tantamount to a conditional sale by the purported lessor to the lessee), the Tax Court rejected the taxpayer's contention that "financial" leases should be judged by different criteria than "operating" leases:

At the outset, we direct our attention to petitioner's argument which stresses that the contracts are "financial leases" and not "operating leases." The argument continues that financial leases are a relatively new phenomenon in the business world and thus should be judged in light of current hybrid financing and rental techniques and not evaluated under the criteria outlined in Rev. Rul. 55-540 or the earlier court cases which make no such distinction. We are not persuaded by this argument and feel constrained to point out that there have been no provisions made in tax law for special consideration to be given to hybrid leases which tend to place the residual rights of the rented property in someone other than the lessor. In the tax realm, such contracts are either leases or they are not, and we make that determination based on tests enunciated in our prior decisions.¹⁸

TAX L. REV. 65 (1955); Zeitlin, *Tax Planning in Equipment-Leasing Shelters*, 1969 SO. CAL. TAX INST. 621.

18. *Northwest Acceptance Corp. v. Commissioner*, 58 T.C. 836 (1972), *aff'd per curiam*, 500 F.2d 1222 (9th Cir. 1974). *Northwest* involved the purchase by a sales finance company of leases between dealers in heavy equipment and their customers. Although the taxpayer lost the first skirmish, when the court held that financial leases are subject to the same criteria as operating leases, the taxpayer went on to win the battle (described by the Tax Court as "extremely close"), since the court found that the arrangement met normal "lease" standards. *Id.* at 844-45. In so holding, the Tax Court relied heavily on its earlier decision in *Lockhart Leasing Co. v. Commissioner*, 54 T.C. 301 (1970), 58 T.C. at 845-49. However, the Court of Appeals for the Tenth Circuit, in affirming *Lockhart Leasing*, expressed the view that Rev. Rul.

Although it applies Rev. Rul. 55-540 to leveraged leases, in 1975 the IRS announced a set of special guidelines applicable to taxpayers requesting an advance ruling that a particular arrangement will be treated as a lease for federal income tax purposes. To qualify for a favorable ruling:

- (a) the lessor must make and maintain a minimum unconditional "at risk" investment in the property of 20 percent of its cost;
- (b) the lessee may not furnish any of the cost of the property;
- (c) the lessee may not have a contractual right to purchase the property from the lessor for less than its fair market value when the right is exercised;
- (d) the lessor must establish that it expects to realize a profit from the transaction, aside from the value of its tax benefits; and
- (e) certain other conditions set out in the IRS announcement must be met.¹⁹

On meeting these requirements, the taxpayers will ordinarily receive a favorable ruling; but failure to satisfy the guidelines will not preclude favorable rulings by the IRS "in appropriate cases on the basis of all the facts and circumstances," nor are the standards intended to describe the legal principles governing whether a transaction is or is not a lease or to be used for audit purposes.²⁰

II. "TAX POLARITY"—REALLOCATION OF LUMP SUM SALES PRICE AMONG INTERRELATED ASSETS

It is frequently necessary to allocate a lump sum sales price among individual interrelated assets, so that the seller can compute gain or loss separately for each item. The buyer must also determine the cost of each item, in order to compute depreciation and gain or loss on subsequent sales of the individual items. If the buyer and seller bargain separately for each item,²¹ so that the aggregate amount paid is merely the sum of the separate prices, like the total on a supermarket cash register tape, it can be accurately allocated back to its separate components. Even if the parties deal on an all-or-nothing basis, an equally accurate allocation is feasible if the package contains nothing but items with readily ascertainable individual prices. But the process of allocating a lump sum among its

55-540 does not apply to taxpayers in the business of leasing property. See *Lockhart Leasing Co. v. Commissioner*, 446 F.2d 269, 272 (10th Cir. 1971).

19. Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Proc. 75-78, 1975-1 C.B. 752. See also Rev. Proc. 76-30, 1976-2 C.B. 647 (no-ruling policy if property is not expected to be useful at end of lease's term except to the lessee); Javaras & Nelson, *The New Leveraged Lease Guidelines*, 53 TAXES 388 (1975). For an earlier ruling in this area, see Rev. Rul. 72-543, 1972-2 C.B. 87 (ship financing arrangement treated as sale).

20. Rev. Proc. 75-21, 1975-1 C.B. 715, at § 3.

21. For the use of sealed bids to establish separate arm's-length prices for assets that would normally be sold in tandem by simulating an auction market, see *Marx v. Commissioner*, 29 T.C. 88 (1957) (sealed bids required by Groucho Marx to distinguish compensation for personal services from payment for literary properties).

components turns from an exact science to a vague art, or even to guesswork, if the transferred property consists of a going business whose constituent items are difficult to value and would not have been sold in isolation, such as real estate, specialized equipment, good will, covenants not to compete, patents, industrial know-how, and franchises.²²

Knowing that they both will have to allocate the aggregate amount paid among the separate assets for tax purposes, the buyer and seller may seek to avoid arguments with the IRS in the future by agreeing on an allocation at the time of the sale. Such an allocation may have some nontax consequences; for example, it may affect the damages to be paid if a particular asset is misrepresented or if the seller breaches his covenant not to compete. Nontax consequences of this type help to establish the validity of the allocation unless they are too speculative to deserve attention. But just as the parties to a purported lease cannot prevent it from being restructured as a sale in appropriate circumstances by showing that the transaction's form will have some nontax consequences,²³ so an allocation of a lump sum sales price does not become sacrosanct simply because it may affect the nontax rights of the parties.

It is sometimes asserted that the buyer and seller ordinarily have opposing tax interests in allocating a lumpsum payment, so that self-interest will evoke an accurate breakdown of the sales price among the constituent items. A typical expression of this theory is: "The tax avoidance desires of the buyer and seller in such a situation are ordinarily antithetical, forcing them, in most cases, to agree upon a treatment which reflects the parties' true intent with reference to the covenants, and the true value of them in money."²⁴

The enlightened self-interest posited by this "tax polarity" theory can be illustrated by a simple example. Assume that a going business is sold for \$100,000, represented by merchandise with a fair market value of \$60,000 and goodwill with a fair market value of \$40,000; that both classes of assets have a zero basis in the seller's hands; and that the seller is subject to a tax rate of 50% on merchandise profits but that gain on the goodwill qualifies for a long-term

22. See generally Beghe, *Income Tax Treatment of Covenants Not To Compete, Consulting Agreements and Transfers of Goodwill*, 30 TAX LAW. 587 (1977); Stansbury, *Advising Clients on Tax Treatment of Goodwill v. Covenant-Not-To-Compete Issue*, 45 J. TAX. 208 (1976).

23. See text accompanying notes 8-20 *supra*.

24. *Ullman v. Commissioner*, 264 F.2d 305, 308 (2d Cir. 1959) (allocation of lump sum amount between stock and covenant not to compete). See also *Balthrope v. Commissioner*, 356 F.2d 28, 32 (5th Cir. 1966) (tax polarity is "a solid barrier to unrealistic allocations"); Treas. Regs. § 1.1245-1(a)(5): "In general, if a buyer and seller have adverse interests as to the allocation of the amount realized [on a sale of two or more assets] between the section 1245 property and the nonsection 1245 property, any arm's-length agreement between the buyer and the seller will establish the allocation."

capital gain rate of 25%. If the \$100,000 sales price is allocated by the parties in accordance with the fair market value of the assets, the seller's tax will aggregate \$40,000, as shown by Table 1.

TABLE 1

TAX RESULT TO SELLER—ALLOCATION BASED ON FAIR MARKET VALUES

Asset	Allocation	Basis	Gain	Tax Rate	Tax
Merchandise	\$ 60,000	\$ 0	\$ 60,000	50%	\$30,000
Goodwill	\$ 40,000	\$ 0	\$ 40,000	25%	\$10,000
Totals	\$100,000	\$ 0	\$100,000		\$40,000

Assuming that the buyer is able in the following year to sell the merchandise for \$80,000 and the goodwill for \$60,000, and that he is also subject to a 50% rate on merchandise profits and to a 25% rate on selling the goodwill, the buyer's aggregate tax liability will be \$15,000, as shown by Table 2.

TABLE 2

TAX RESULT TO BUYER ON SUBSEQUENT SALE—ALLOCATION BASED ON FAIR MARKET VALUES

Asset	Proceeds of Sale	Basis	Gain	Tax Rate	Tax
Merchandise	\$ 80,000	\$ 60,000	\$20,000	50%	\$10,000
Good-will	\$ 60,000	\$ 40,000	\$20,000	25%	\$ 5,000
Totals	\$140,000	\$100,000	\$40,000		\$15,000

If the parties do not allocate the sales price of \$100,000 in proportion to the respective fair market values of the merchandise and goodwill, one of them will suffer a disadvantage. Table 3 illustrates the adverse effect on the seller (and the favorable effect on the buyer) of an excessive allocation (\$80,000) to the merchandise, resulting in an offsetting underallocation (\$20,000) of the sales proceeds to the goodwill.

TABLE 3

TAX RESULTS TO SELLER AND BUYER—EXCESSIVE ALLOCATION
TO MERCHANDISE*A. Result to Seller on Initial Sale*

Asset	Allocation of Proceeds	Basis	Gain	Tax Rate	Tax
Merchandise	\$ 80,000	\$ 0	\$ 80,000	50%	\$40,000
Goodwill	\$ 20,000	\$ 0	\$ 20,000	25%	\$ 5,000
Totals	\$100,000	\$ 0	\$100,000		\$45,000

B. Result to Buyer on Subsequent Sale

Asset	Proceeds of Sale	Basis	Gain	Tax Rate	Tax
Merchandise	\$ 80,000	\$ 80,000	\$ 0	50%	\$ 0
Goodwill	\$ 60,000	\$ 20,000	\$40,000	25%	\$10,000
Totals	\$140,000	\$100,000	\$40,000		\$10,000

Table 4 demonstrates the converse of Table 3—the favorable effect on the seller (and the adverse effect on the buyer) of an under-allocation to merchandise (\$40,000), coupled with a corresponding overallocation (\$60,000) to the goodwill.

TABLE 4

TAX RESULTS TO SELLER AND BUYER—EXCESSIVE ALLOCATION
TO GOODWILL*A. Result to Seller on Initial Sale*

Asset	Allocation of Proceeds	Basis	Gain	Tax Rate	Tax
Merchandise	\$ 40,000	\$ 0	\$ 40,000	50%	\$20,000
Goodwill	\$ 60,000	\$ 0	\$ 60,000	25%	\$15,000
Totals	\$100,000	\$ 0	\$100,000		\$35,000

B. Result to Buyer on Subsequent Sale

Asset	Proceeds of Sale	Basis	Gain	Tax Rate	Tax
Merchan- dise	\$ 80,000	\$ 40,000	\$40,000	50%	\$20,000
Goodwill	\$ 60,000	\$ 60,000	\$ 0	25%	\$ 0
Totals	\$140,000	\$100,000	\$40,000		\$20,000

Although Tables 1-4 demonstrate that an arbitrary allocation of the agreed \$100,000 sales price will adversely affect one party at the expense of the other, when compared with an allocation corresponding to the fair market values of the assets, it does *not* follow that the parties will always select the true-value allocation. Since the aggregate amount of taxes to be paid by the seller and buyer is the same (\$55,000) regardless of the allocation, they may well want to bargain about the division of this burden between them. Assuming that the true values of the assets are sufficiently debatable so that any of the three allocations can be supported by satisfactory evidence, there is no more reason for them to select the allocation reflected by Tables 1 and 2 than the allocations shown in Table 3 or Table 4. Moreover, if they know in advance that the courts will accept whatever allocation they adopt because of their alleged "tax polarity," the allocation they chose will depend on their respective bargaining power, not on the fair market values of the assets.

Finally, there is a reciprocal relationship between the sales price (assumed in the example to be \$100,000), and its allocation between the assets; and this means that the parties can alter *both* the sales price *and* the allocation, without affecting the aggregate tax burden or their after-tax positions. Thus, reducing the sales price from \$100,000 to \$95,000 will produce the same after-tax results as Tables 1 and 2, if the reduced sales price is allocated for tax purposes between merchandise and goodwill in the proportion 45/50. Conversely, increasing the sales price to \$105,000 will also produce the same after-tax results as Table 1 if the merchandise is valued at \$75,000 and the goodwill at \$30,000.²⁵

25. The following is a mathematical demonstration of this point.

Let x = amount allocated to goodwill.

y = amount allocated to merchandise.

Assuming the seller has a zero basis for both the assets, his tax is $(1/2)y + (1/4)x$. His after-tax receipts are thus $x + y - \text{tax}$, or $x + y - (1/2)y + (1/4)x$, which will be set equal to 60, his receipts (in thousands of dollars) under the initial arrangement.

The buyer's bases will be y and x on the merchandise and goodwill, respectively. His

The example used for Tables 1-4 assumes that the buyer and seller are subject to the same marginal tax rates and does not take account of differences in the taxable years when the income attributable to the transaction will be reported. If we posit divergent tax rates for buyer and seller and/or timing differences between them, their allocation of a lump sum sales price cannot only shift the tax burden from one party to the other, but also—if accepted by the IRS—alter their *aggregate* tax burden.

This possibility can be illustrated by varying the example and assuming that the buyer is a tax-exempt institution, which does not care how the aggregate amount to be paid is allocated among the constituent items. On this assumption, the seller's tax liability can be reduced from \$40,000 (Table 1) to \$35,000 (Table 4) by a 40/60 allocation of the \$100,000 sales price to the merchandise and goodwill, respectively—and this reduction in the seller's tax will cost the tax-exempt buyer nothing. Generated at the expense of the Treasury, which is absent from the bargaining table, this tax savings can be shared by the seller with the buyer in the form of a reduced sales price. In short, instead of allocating an *agreed* sales price in proportion to the values of the assets being sold, tax-conscious parties can sometimes minimize the aggregate tax liability so that the anticipated tax savings becomes an element in *determining* the sales price.

The simplified example used to illustrate this phenomenon posits, for convenience, a tax-exempt buyer; but similar possibilities

after-tax receipts, assuming a later sale of the business for 140, are: $140 - (x + y) - (1/2 (80 - y) - 1/4 (60 - x))$. This quantity is set equal to 25, again in accordance with the initial arrangement.

The two resulting equations each simplify to give $2y + 3x = 240$. Avoiding the complications that would be introduced by losses on any of the sales, x can go as high as 60, and y can go as high as 80, the amounts for which these assets are resold by the buyer in the later year.

Within these limits, any values of x and y which satisfy the above equation will leave the positions of the parties unchanged. The total sales price will vary between 90 and $106 \frac{2}{3}$, while the actual allocation between goodwill and merchandise will vary tremendously. (If losses were allowed, even greater variability in the total sales price could take place.) The following values are representative:

Total Sales Price	Allocated to Merchandise (y)	Allocated to Goodwill (x)	Seller's Tax	Buyer's Tax	Profits	
					Seller	Buyer
90	30	60	30	25	60	25
95	45	50	35	20	60	25
100	60	40	40	15	60	25
105	75	30	45	10	60	25
$106 \frac{2}{3}$	80	$26 \frac{2}{3}$	$46 \frac{2}{3}$	$8 \frac{1}{3}$	60	25

exist whenever the private parties are in different tax brackets, will recognize the income and deductions attributable to the transaction in different years, or have other divergent tax attributes (e.g., loss carryovers).²⁶ Thus, the clash of enlightened self-interest will not necessarily produce an allocation corresponding to fair market values.

The possibility that one party to a business bargain will gain more from an arbitrary allocation of an agreed amount than the other will lose has not gone unnoticed by the courts. An example is the following description by the Court of Appeals for the Ninth Circuit of the sale of a winery and its merchandise inventory by a seller wishing to maximize the long-term capital gain component of his profit:

Tiara [the buyer] informed petitioner [the seller] that it did not care how he allocated the purchase price so long as the total price did not exceed the agreed \$350,000. Petitioner had been advised by his accountant that the sale of his winery would result in a capital gains tax whereas [gain on] the wine would be subject to ordinary income tax. The tax consequence of assigning a high valuation to the winery and a low valuation to the wine inventory was undoubtedly understood by petitioner. He therefore drew up the contract specifying separate prices for the wine and winery to suit his own convenience. The price allocated to the wine in the contract certainly did not represent the true value or the value contemplated by both parties and bears no resemblance to the realities of the transaction. The total purchase price was arrived at through arms length negotiation but the allocation of the selling price to the two pieces of property involved was not. Once the parties had agreed upon the purchase price it was a matter of indifference to the buyer to how the seller allocated it. The argument that the valuation placed on the wine and winery was of vital importance to Tiara because it necessarily affected its income tax position has no merit. That argument wholly ignores the crucial fact that the federal income tax is a graduated tax and a given transaction may have different consequences depending upon the circumstances of the particular taxpayer.²⁷

26. There are other situations in which the parties are not hostile. For example, in allocating an agreed amount among a group of depreciable assets, the buyer ordinarily would prefer a high valuation for short-lived assets and a low valuation for long-lived assets, since this will accelerate his depreciation deductions. Since gain on both classes of depreciable assets is ordinarily taxed as capital gain under I.R.C. § 1231, the seller may not care how the aggregate amount is allocated among them. A corporation concerned about preserving a good earnings record may be willing, on purchasing a going business, to accept a low value for inventory, which will inflate its subsequent earnings, despite the increased tax liability. If the allocation results in a higher value for the goodwill, earnings for financial reporting purposes will be reduced by amortization, but only over a 40-year period. For the accounting treatment of goodwill, see A.P.B. Ops. Nos. 16, 17 (as amended).

27. *Particelli v. Commissioner*, 212 F.2d 498, 501 (9th Cir. 1954). See also *Lemery v. Commissioner*, 52 T.C. 367, 376 (1969), *aff'd per curiam*, 451 F.2d 173 (9th Cir. 1971) (seller of

Occasionally an allocation is fictitious to the point of fraud, as illustrated by the following anecdote by Randolph Paul:

It is easy to give illustrations of prevailing techniques of misrepresentation. One favorite device is to put a transaction into two contracts, one of which is to be shown to the Government's representatives, and the other of which is to be kept secret. This happened once in my experience in connection with a sale of stock to a buyer for about \$5 million. Since the buyer had an option on the stock of about \$3 million, it was obvious that \$2 million was being paid for an agreement not to compete. A payment for this covenant would have been ordinary income and not capital gain. The seller insisted that this transaction be put in two documents, one of which would recite the sale of stock for \$5 million, and the other of which would provide against competition without mentioning any consideration. I felt obliged to refuse to be an adviser in this transaction. As a result, my client, who had reluctantly agreed because of anxiety to procure the stock, went to another attorney who was willing to let the client do what the seller wished. The client never came to me with his subsequent problems.²⁸

If the allocation has significant nontax consequences they should, of course, count in its favor, and within limits, so should the opposing tax interests of the parties, if they have not ganged up on the IRS. On the other hand, it should occasion no surprise that agreed allocations of lump-sum payments are often subjected to administrative and judicial scrutiny, rather than accepted at face value.

III. ROLE OF THE PAROL EVIDENCE RULE

The parol evidence rule is only a shadow of its former self in the contemporary law of contracts,²⁹ but it is frequently imported into the tax area by taxpayers hoping to bar the restructuring of a transaction or by the IRS as a defense against a taxpayer's effort to escape from the language of a written agreement. Although these attempts to exclude parol evidence are almost invariably unsuccessful, they recur with such regularity as to justify a more fundamental examination of the parol evidence rule's function than is ordinarily to be found in the tax decisions. As summarized by Corbin, the rule is as follows:

When two parties have made a contract and have expressed it in a writing to which they have both assented as the complete and

stock with covenant not to compete did not care how purchase price was allocated because stock had been held for less than 6 months and tax liability would be the same whether profit was taxed as ordinary income or as short-term capital gain).

28. Paul, *The Lawyer as a Tax Adviser*, 25 ROCKY MTN. L. REV. 412, 421 (1953).

29. See CALAMARI & PARILLO, *THE LAW OF CONTRACTS* 97-131 (2d ed. 1977); J. MURRAY, *CONTRACTS* § 225 (2d rev. ed. 1974); Sweet, *Contract Making and Parol Evidence: Diagnosis and Treatment of a Sick Rule*, 53 CORNELL L.Q. 1036 (1968).

accurate integration of that contract, evidence, whether parol or otherwise, of antecedent understandings and negotiations will not be admitted for the purpose of varying or contradicting the writing.³⁰

The parol evidence rule has been described as a legal concept “whose mysteries are familiar to many but fathomed by few,”³¹ but it is quite obvious that written agreements are rarely, if ever, restructured *for federal tax purposes* in order to reinstate a prior inconsistent understanding between the parties. Indeed, many transactions are restructured even though there was *no* prior understanding between the parties. Under Rev. Rul. 55-540, for example, a purported lease is viewed as a sale if its terms satisfy certain conditions, all of which look to the agreement *as written* rather than to any prior negotiations or understandings between the parties.³²

This is not to suggest that prior discussions are irrelevant in determining whether an agreement should be restructured. To the contrary, if, for example, a purported lease with an option to purchase was preceded by an oral offer to purchase or sell the property, the price bid or asked can help to establish whether “the total of the rental payments and any option price payable in addition thereto approximates the price at which the equipment could have been acquired by purchase at the time of entering the agreement, plus interest and/or carrying charges,” which under Rev. Rul. 55-540 generally denotes a sale.³³ The unaccepted offer to purchase or sell the property is evidence—indeed, it may be the best evidence—of the equipment’s normal sale price; but since the evidence is not used to vary or contradict the obligations of the parties under subsequent written agreement in any way, the parol evidence rule is not contravened.³⁴

The relationship of the parol evidence rule to attempts to restructure business transactions should be distinguished from other situations in which it is more pertinent. When the federal income tax consequences of a transaction turn on a taxpayer’s rights and duties under a written contract whose meaning is disputed, the taxpayer or the IRS may offer evidence of prior negotiations or understandings between the parties in order to clarify or alter the meaning of the contract or to establish that it was not intended to be enforced. Since what is ordinarily at stake in these cases is the legal effect of the agreement under state law, the proffered evidence is relevant only if

30. A. CORBIN, *CONTRACTS* § 573 (1960). See also *RESTATEMENT (SECOND) OF CONTRACTS* (Tent. Drafts Nos. 1-7) § 239 (1973); 4 S. WILLISTON, *CONTRACTS* § 631 (3d ed. 1961).

31. MURRAY, *supra* note 29, at 226.

32. Rev. Rul. 55-540, 1955-2 C.B. 39.

33. *Id.* § 4.05.

34. See *Taft v. Commissioner*, 27 B.T.A. 808 (1933) (unequivocal offer to purchase property used to determine substance of transaction; purported lease treated as sale).

it affects the rights and duties of the parties. Thus, it is necessary to determine whether the parol evidence rule (which, despite its label, is a rule of substantive law rather than a rule of evidence) would, under the law of the appropriate state, permit or bar this use of the pre-agreement discussions.³⁵

It is sometimes suggested that the IRS, being "a stranger to the contract,"³⁶ is not bound by, and cannot invoke, the parol evidence rule. Neither of these notions is well-founded if the issue to be decided is the legal effect of the written agreement on the private parties who executed it. In this situation, the IRS should have the same power that the parties have to resort to their prior understandings to clarify the scope or meaning of the agreement as executed. In this connection, it should be noted that the contemporary trend in the law of contracts, which may or may not prevail in any given state, is to enlarge these sources of enlightenment rather than restrict them.³⁷

IV. ATTEMPTS BY TAXPAYERS TO RESTRUCTURE TRANSACTIONS

If the IRS is content to accept a transaction at face value, can one of the parties take the initiative and demand that it be restructured to conform to economic reality? The courts have vacillated between allowing taxpayers to invoke the substance-over-form doctrine as freely as the IRS and letting them stew in their own juices if that appeals to the government's appetite. On the whole, however, the courts tend to apply the two-way street approach when taxpayers endeavor to restructure a transaction to conform to its substance.

This tolerance may reflect a judicial feeling that the issue in most restructuring cases is the legal category to which the transaction belongs; that its classification should not depend on the labels used by the parties, even if they were deliberately chosen for their emotive affect; and that the words of the contract are not a representation of facts (giving rise to an estoppel), but only a reflection of an opinion about the transaction's legal status (which should not induce reliance by the IRS). In at least one area—attempts by a taxpayer to establish that a sale-and-leaseback or similar transaction was tantamount to a mortgage—there is a long common law tradition, rooted in prohibitions on usury, allowing borrowers to disavow the form of an agree-

35. For an excellent discussion, see *Estate of Craft v. Commissioner*, 68 T.C. 249, 268 (1977) (Simpson, J., concurring) (distinguishing situations in which a tax provision turns on actual behavior rather than on the extent of the taxpayer's rights under state law). See also *Clark v. United States*, 341 F.2d 691 (9th Cir. 1965) (taxpayer not allowed to introduce parol evidence to contradict integrated contract, where tax results depended on its legal effect). For other illustrations of the problem, which are less thoroughly analyzed, see *Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966), *cert. denied*, 387 U.S. 905 (1967) (effect of stock purchase agreement).

36. See, e.g., *Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966).

37. See note 29 *supra*.

ment, even if deliberately chosen.³⁸ Although it might be argued that revenue agents should be allowed to rely on the labels chosen by taxpayers in order to expedite tax administration, the principal IRS rulings in the restructured transaction area establish standards that can evidently be invoked by taxpayers to establish that a purported lease is a sale.³⁹ While delay and inefficiency may result from allowing taxpayers to repudiate the form in which they chose to cloak a transaction, these rulings imply that the administrative cost is not excessive.

A burgeoning exception to these principles, however, has developed with respect to agreed allocations of the sales price in contracts for the sale of a going business or the stock of an incorporated enterprise, when accompanied by a covenant not to compete. If the IRS chooses to hold the parties to the allocation, it is ordinarily allowed to do so unless the taxpayer establishes that the allocation is fictitious by greater proof than is required in ordinary tax cases. As usually formulated, this heavier burden entails "strong proof" by the taxpayer,⁴⁰ but the Court of Appeals for the Third Circuit has escalated the standard to the level required to vary the terms of a written contract under common law—proof that the allocation was induced by mistake, fraud, duress, or undue influence.⁴¹

Under this acting criterion, a party who was not represented by counsel can escape from an agreed allocation if it was represented as a formal recital having no legal effect on him; but in virtually all other circumstances, the allocation would be binding if the IRS elected to hold the taxpayer to it.⁴² To justify imposing an abnormal burden of proof on taxpayers seeking to disavow an allocation, these decisions argue that the agreement should ordinarily be controlling for a number of reasons: the "tax polarity" of the parties; the possibility of denying a bargained-for tax advantage to the taxpayer's opposite number; the administrative burden imposed on the IRS,

38. See *Frank Lyon Co. v. United States*, 98 S. Ct. 1291 (1978); *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939).

39. See, e.g., Rev. Rul. 55-540, 1955-2 C.B. 39.

40. *Montesi v. Commissioner*, 340 F.2d 97 (6th Cir. 1965); *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959).

41. *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967). See also *Dakan v. United States*, 492 F.2d 1192 (Ct. Cl. 1974); Koff, *Judicial Treatment of Covenants Not to Compete: The Third Circuit Takes a Giant Step*, 24 TAX L. REV. 513 (1969).

In *Freeport Transport, Inc. v. Commissioner*, 63 T.C. 107 (1974), the court refused to apply *Danielson* to a case appealable to the Court of Appeals for the Third Circuit, where both parties were before the Tax Court, because "[t]o do so would produce a wholly incompatible result in two related cases, consolidated on motion by the respondent, for the sole purpose of protecting the revenues." *Id.* at 115.

42. See *Proulx v. United States*, 40 A.F.T.R.2d 6168 (Ct. Cl. 1977), where a trial judge of the Court of Claims found that a covenant not to compete had "no significant economic reality" but that the amount allocated thereto by the parties could not be disregarded under the *Danielson* rule.

which may have to litigate with both taxpayers and may be whip-sawed by inconsistent decisions; and the difficulty of placing separate values on items that would not have been sold in isolation.⁴³ All of these factors deserve some weight; however, except for the last point, they are not unique to allocation cases, but can be encountered whenever a taxpayer seeks to restructure a two-party transaction. But in ordinary restructuring cases, the customary burden of proof that taxpayers must bear when suing to set aside a deficiency or get a refund has evidently been adequate.

Sometimes the parties to an agreed allocation buttress it with an explicit agreement to use the same figures in reporting the transaction to the IRS. On violating an implicit commitment to this effect, a buyer was held liable for the legal fees incurred by the seller in successfully defending itself in a resulting tax case.⁴⁴ If the allocation

43. See *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967) (unjust enrichment to the taxpayer, since the sales price may take into account the anticipated tax results of the allocation; administrative burden; and possible whip-saw of IRS); *Uilman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959) ("antithetical" tax interests of buyer and seller tend to induce allocations based on "true value"). In *UMCO Corp. v. Commissioner*, 32 T.C.M. 1009 (CCH) (1973), the Tax Court treated the strong proof rule as a corollary of the "tax polarity" thought to be typical of transactions involving goodwill and covenants not to compete, observing: "Whether such a rule would be applied in situations other than the covenant not to compete-goodwill allocation cases where conflicting tax interests exist need not be decided here, for in this case there is no showing of any such tax conflict." *Id.* at 1011.

On the extent to which taxpayers' efforts to control the tax results of a transaction should be controlling, see *Bennett v. Commissioner*, 58 T.C. 381 (1972):

Respondent [the IRS] also urges that Jones [the other contracting party] would not have assented to the transaction if petitioner [the taxpayer] had not agreed to allow it to take the form of a purchase of the stock from him and, on this ground, insists that we are precluded from holding that the arrangement was a redemption from Jones. However, in any transaction where the form differs from the substance, such difference is presumably dictated by someone who has the power to change the natural form of the transaction. The fact that the one causing such a change has the power to prevent the transaction from occurring in any other way is not sufficient, in itself, to show that the form chosen reflects the substance of the transaction.

Id. at 389.

See also *Bartels v. Birmingham*, 332 U.S. 126 (1947) (superfluous contractual provisions do not affect determination of "employee" status for purposes of employment tax and hence cannot shift tax liability from one entity to another); *Robinson v. Elliot*, 262 F.2d 383, 385 (9th Cir. 1958) (lease with option to purchase held to be a sale, as contended by seller, as to impact of this decision on the lessee-purchaser, when such a party hopes to save taxes, he "will just have to take a gamble that his legal format will stick").

For concern with the administrative burden on the IRS, see *Leisure Dynamics, Inc. v. Commissioner*, 494 F.2d 1340, 1347 (8th Cir. 1974) (Stuart, J., dissenting).

For stress on valuation difficulties, see *Schulz v. Commissioner*, 294 F.2d 52, 55 (9th Cir. 1961) ("impossible task of assigning fair values to goodwill and to covenants"); *Amerada Hess Corp. v. Commissioner*, 517 F.2d 75, 85 (3d Cir.), cert. denied, 423 U.S. 1037 (1975) ("only the parties to [a covenant not to compete] could value it; there exists no outside valuation index").

44. *Stern & Co. v. State Loan & Fin. Corp.*, 238 F. Supp. 901 (D. Del. 1965) (applying Pennsylvania law). See also *Penn-Ohio Steel Corp. v. Allis-Chalmers Mfg. Co.*, 280 N.Y.S.2d 679 (N.Y. App. Div. 1967), aff'd per curiam, 21 N.Y.2d 916, 289 N.Y.S.2d 753 (1968) (damage award for giving misleading information to IRS reversed for insufficient evidence); *Problems in Acquiring a Business: A Panel Discussion*, 26 N.Y.U. INST. FED. TAX. 815, 822 (1968); Note, *Tax Consequences of Asset Valuations in Arm's Length Agreements Between Unrelated Parties*, 27 TAX L. REV. 145, 146-47 (1971).

had been set aside in the tax case, however, holding the buyer liable for the seller's legal expenses would have smacked of a penalty for properly reporting the transaction. Moreover, a contract designed to discourage a taxpayer from reporting a transaction in accordance with his best judgment when the return is filed, even if it turns out to be wrong, might be viewed as contrary to public policy.

V. CONSISTENCY IN RESTRUCTURING TWO-PARTY TRANSACTIONS

In theory, when a two-party transaction is restructured or an agreed amount is reallocated in accordance with the principles discussed above, the new characterization should apply to both parties, and the IRS ordinarily endeavors to achieve this objective. For example, if a seller disputes the validity of an agreed allocation, the IRS usually assesses deficiencies against both parties,⁴⁵ while acknowledging that only one deficiency should be ultimately upheld.⁴⁶ This tactic resembles an interpleader action, except that the IRS is not an indifferent stakeholder of a fixed amount, since the opposing tax burdens of the private parties will almost never be identical. Moreover, unless the dispute is purely factual, the potential precedential weight of the cases ordinarily leads the IRS to prefer one outcome over the other.

The IRS has no formal administrative tools to compel consistency of treatment, since the two cases, if litigated, may eventually be decided by different appellate courts. For this reason, the IRS may win, or lose, both cases. If it wins the first to be litigated, however, inconsistency can be avoided by a government concession in the other case. The prospect of consistency is enhanced if the cases are consolidated in the Tax Court, since any issues of fact are likely to be

45. If the IRS neglects to move promptly, and the first taxpayer eventually wins, the statute of limitations may bar an action against the second contracting party. I.R.C. §§ 1311-1314, mitigating the effect of the statute of limitations, do not treat buyers and sellers as "related taxpayers." These mitigation provisions do apply, however, with respect to all tax years of each party separately; thus, if the seller is able to escape from an agreed allocation, deficiencies, if appropriate, can be assessed for all earlier years, not merely for "open" years, in order to insure consistency. See generally Coleman, *Mitigation of the Statute of Limitations—Sections 1311-15*, 31 N.Y.U. INST. FED. TAX. 1575 (1973); Note, *Sections 1311-15 of the Internal Revenue Code: Some Problems in Administration*, 72 HARV. L. REV. 1536 (1959).

46. See *Dixie Fin. Co. v. United States*, 474 F.2d 501 (5th Cir. 1973), where the government won both cases at the trial level (one in the Tax Court and the other in a federal district court), but announced that if one decision was affirmed, it would accept a reversal of the other. See also *Goodall v. Commissioner*, 391 F.2d 775 (8th Cir.), cert. denied, 393 U.S. 829 (1968) (inconsistent deficiencies not improper, where ultimate consistent treatment of alternate taxpayers is intended and determination is not frivolous); *Goldstein v. United States*, 227 F.2d 1, 5 (8th Cir. 1955) (quoting IRS commitment to treat other parties consistently with result in litigated case); *Oesterreich v. Commissioner*, 226 F.2d 798 (9th Cir. 1957); *Wilshire Holding Corp. v. Commissioner*, 224 F.2d 904 (9th Cir. 1957).

resolved in the same way for both parties.⁴⁷ Unfortunately, harmony is not guaranteed even in this situation. Each taxpayer has the burden of proof in his own case, and one might fail to convince the judge that a witness is telling the truth, while the other simultaneously fails to prove by the requisite standard that the same witness is mistaken.⁴⁸ The prospect of inconsistent findings at the trial level is increased if one case is tried in the Tax Court and the other in a federal district court.⁴⁹ Because of the current lack of enforceable safeguards against inconsistent treatment of either the IRS or related parties, legislative measures against "whip-saw" have been actively discussed in recent years.⁵⁰ Much can be said for procedural rules that, while continuing to permit transactions to be restructured in accordance with their substance, would increase the likelihood of consistent treatment of the same transaction by the IRS and all private parties thereto.

VI. CONCLUSION

Parties entering into a business transaction are generally free to structure the transaction in any way that they see fit. For federal tax purposes, however, the IRS and the courts have a long history of restructuring business transactions to reflect economic reality. Sales that are disguised as leases and lump-sum sale prices misallocated among interrelated assets are prime candidates for restructuring. While a taxpayer may seek to restructure a business transaction in order to receive more favorable tax treatment, in some courts at least, the taxpayer must meet a heavy burden of proof. The parol evidence rule is often invoked by taxpayers facing reallocation, but the rule is only relevant when the IRS seeks to alter the terms of the transaction by proof of a prior oral agreement. It is not available when the only issue is how a transaction, the terms of which are not in dispute, should be characterized.

47. See, e.g., *Schulz v. Commissioner*, 294 F.2d 52 (9th Cir. 1961) (consolidated cases tried in Tax Court and appealed to same appellate court).

48. For discussion of the burden of proof in consolidated cases, see *Freeport Transp., Inc. v. Commissioner*, 63 T.C. 107 (1974). See also *Drummond v. Commissioner*, 35 T.C.M. 243, 249 (CCH) (1976) ("[b]oth parties have the burden of proving that respondent's determination is erroneous, and respondent's position as stakeholder does not alter this rule" (footnote omitted)).

49. See *Dixie Fin. Co. v. United States*, 474 F.2d 501 (5th Cir. 1973).

50. See *ABA Tax Section, Final Report of Special Committee on Whipsaw*, 30 TAX LAW. 127 (1976); Lake, *The Whipsaw Problem in Federal Tax Controversies*, 34 N.Y.U. INST. FED. TAX. 867 (1976). For a general survey, see Plumb, *The Problem of Related Taxpayers: A Procedural Study*, 66 HARV. L. REV. 225 (1952).