[JOINT COMMITTEE PRINT]

PRESENT LAW AND PROPOSALS RELATING TO THE FEDERAL INCOME TAX TREATMENT OF THE COST OF ACQUIRING GOODWILL AND CERTAIN OTHER INTANGIBLES

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON APRIL 28, 1992

PREPARED BY THE STAFF

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on April 28, 1992, to consider the Federal income tax treatment of the cost of acquiring goodwill and certain other intangible assets. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the present-law tax rules, a description of two legislative proposals that would modify the present-law tax rules, and a discussion of issues relating to the present-law tax rules and the two legislative proposals.

Part I of the pamphlet contains a summary of present law and the two legislative proposals. Part II provides a more detailed description of the present-law tax rules and background relating to the treatment of the cost of acquiring intangible assets. Part III provides a more detailed description of the two legislative proposals: (1) section 4501 of H.R. 4210, as passed by Congress on March 20, 1992, and vetoed by the President; and (2) S. 1245, as introduced by Senators Daschle and Symms on June 6, 1991. Part IV provides a discussion of issues relating to the present-law tax rules and the two legislative proposals.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Present Law and Proposals Relating to the Federal Income Tax Treatment of the Cost of Acquiring Goodwill and Certain Other Intangibles* (JCS-9-92), April 27, 1992.

I. SUMMARY

Present law

In determining taxable income for Federal income tax purposes, taxpayers are allowed depreciation deductions for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or that is held for the production of income. Under Treasury Department regulations, no depreciation deductions are allowed with respect to intangible property unless the intangible property has a limited useful life that may be determined with reasonable accuracy. In addition, under the same Treasury Department regulations, no depreciation deductions are allowed with respect to goodwill or going concern value.

Numerous court decisions and Internal Revenue Service pronouncements have addressed whether depreciation deductions are allowed with respect to intangible property. In general, a taxpayer must establish that the intangible property is distinguishable from goodwill or going concern value and that the intangible property has a limited useful life that is determinable with reasonable accuracy. Because this is essentially a factual determination, different results have often been reached in different cases with respect to the same or similar types of intangible property.

H.R. 4210

Section 4501 of H.R. 4210 [2] would allow an amortization deduction with respect to the capitalized costs of goodwill, going concern value, and certain other intangible property that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction would be determined by amortizing the adjusted basis of the intangible ratably over a 14-year period.

Section 4501 of H.R. 4210 generally would apply to specifically defined intangible property whether acquired as part of the acquisition of a trade or business or as a single pre-existing asset. The bill would not change the Federal income tax treatment of self-created intangible property, such as goodwill that is created through advertising or other similar expenditures.

The provision generally would apply to property acquired after the date of enactment. A taxpayer, however, would be allowed to elect to apply a version of the provision to either (1) all property

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[2] H.R. 4210, the "Tax Fairness and Economic Growth Act of 1992," was passed by Congress on March 20, 1992, and was vetoed by the President. See H. Rept. No. 102-461 (Conference Report), March 20, 1992, pp. 190-200 and 545-566. Section 4501 of H.R. 4210 was derived from H.R. 3035. For a description of H.R. 3035 and related House bills, see Joint Committee on Taxation, *Description of Proposals Relating to the Federal Income Tax Treatment of Certain Intangible Property (H.R. 3035, H.R. 1456, and H.R. 563)* (JCS-14-91), September 30, 1991.

acquired after July 25, 1991, or (2) all property acquired in certain taxable years for which the statute of limitations for the assessment of tax has not expired.

S. 1245

S. 1245, as introduced by Senators Daschle and Symms on June 6, 1991, would amend section 167 of the Internal Revenue Code to provide that if a taxpayer demonstrates through any reasonable method that (1) customer base, market share, or any other similar intangible item has an ascertainable value that is separate and distinct from other assets (including goodwill and going concern value) acquired as part of the same transaction, and (2) the intangible item has a limited useful life which can be reasonably estimated, then the basis of the intangible shall be amortized over such useful life.

In addition, S. 1245 would grant the Treasury Department the authority to promulgate regulations establishing safe harbor useful lives for specific classes of customer base, market share, or other similar intangible items which are generally consistent with the actual useful lives for the items within such classes. In addition, the Treasury Department would be authorized to promulgate regulations concerning the manner in which such intangible items may be valued separately and distinctly from other assets (including goodwill and going concern value).

S. 1245 would apply to all open taxable years (i.e., all taxable years for which the statute of limitations has not expired).

II. BACKGROUND AND PRESENT LAW

In general

Under section 167 of the Internal Revenue Code, taxpayers are allowed depreciation deductions for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or that is held for the production of income. Under Treasury Department regulations, no depreciation deductions are allowed with respect to intangible property unless the intangible property has a limited useful life that may be determined with reasonable accuracy.[3] In addition, under the same Treasury Department regulations, no depreciation deductions are allowed with respect to goodwill.

Thus, in order for depreciation or amortization [4] deductions to be allowed for Federal income tax purposes with respect to intangible property, a taxpayer generally must establish that the property is distinguishable from goodwill and that the property has a limited useful life that is determinable with reasonable accuracy. Numerous court decisions and Internal Revenue Service (IRS) pronouncements have addressed whether these requirements have been satisfied with respect to different types of intangible property. The determination whether depreciation deductions are allowed with respect to intangible property is dependent on all the facts and circumstances. In certain situations, however, the IRS and some courts have suggested that certain results should be considered a matter of law. Often, different results have been reached in different cases with respect to the same or similar types of intangible property.

Issues regarding the amortization of intangible assets frequently arise in the context of the acquisition of a business enterprise. If the price paid to acquire a trade or business exceeds the value of the tangible assets of the trade or business, the purchaser generally must allocate such excess either to (1) goodwill or going concern value, which are not depreciable or amortizable for Federal income

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[3] Treas. Reg. sec. 1.167(a)-3 provides that:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

[4] The deductions allowed for the exhaustion, wear and tear, and obsolescence of intangible property that is used in a trade or business or that is held for the production of income are often referred to as amortization deductions.

tax purposes, or (2) other intangible assets, which may be depreciable or amortizable for Federal income tax purposes.[5]

The following discussion illustrates some of the issues and inconsistencies that arise under present law.

Treatment of certain customer-based intangibles

Taxpayers that have acquired a trade or business have often allocated a portion of the purchase price to customer lists, subscription lists, client records, and other similar intangible assets that represent the customer base of the trade or business. A recurring issue for Federal income tax purposes has been whether a value and life for such intangible assets can be identified that is separate and distinct from goodwill, which generally has been defined as "the expectancy that old customers will resort to the old place" [6] or "the expectancy of continued patronage, for whatever reason." [7]

In a number of cases decided prior to 1973, the courts generally held that customer lists and other similar customer-based intangibles are "related to" or "in the nature of" goodwill and, consequently, no depreciation or amortization deductions are allowed with respect to such assets. In many of these cases, the IRS successfully argued that such customer-based intangibles are "mass assets," the value of which may fluctuate as particular customers are lost and others replace them. These mass assets were considered to provide an inexhaustible benefit and have an indefinite useful life.

For example, in *Golden State Towel and Linen Service, Ltd. v. United States*,[8] the Court of Claims denied a depreciation or loss deduction with respect to a customer list that was acquired in connection with the purchase of the assets of a linen business. The court held that a terminable-at-will customer list is an indivisible asset that is indistinguishable from goodwill. The court found that while the list is subject to temporary attrition as well as expansion due to the departure of old customers and the addition of new customers, no deduction is allowed for Federal income tax purposes for the normal turnover of customers.[9]

In 1973, however, the Fifth Circuit Court of Appeals in *Houston Chronicle Publishing Company v. United States* [10] held that the "mass asset" theory does not preclude depreciation or amortization deductions with respect to customer-based intangibles. In *Houston*

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[5] See section 1060 of the Code and the regulations thereunder which provide rules for the allocation of the purchase price among assets in the case of certain acquisitions occurring after May 6, 1986.

[6] *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963).

[7] *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). See, also, *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3rd Cir. 1991), *cert. granted*, April 6, 1992.

[8] 373 F.2d 938 (Ct. Cl. 1967).

[9] See, also, *Danville Press, Inc. v. Commissioner*, 1 B.T.A. 1171 (1925) (no depreciation deductions allowed with respect to newspaper subscribers); *Boe v. Commissioner*, 35 T.C. 720 (1961), *aff'd* 307 F.2d 339 (9th Cir. 1962) (no depreciation or loss deductions allowed with respect to medical service contracts); *Westinghouse Broadcasting Co. v. Commissioner*, 36 T.C. 912 (1961) (no depreciation deductions allowed with respect to spot advertising contracts); *Scalish v. Commissioner*, 21 T.C.M. 260 (1962) (no depreciation deductions allowed with respect to cigarette vending machine location leases); *Thoms v. Commissioner*, 50 T.C. 247 (1968) (no depreciation deductions allowed with respect to insurance expirations); and *Marsh & McLennan, Inc. v. Commissioner*, 51 T.C. 56 (1968), *aff'd* 420 F.2d 667 (3rd Cir. 1970) (same). But, see, *Seaboard Finance Co. v. Commissioner*, 367 F.2d 646 (9th Cir. 1966) (depreciation deductions allowed with respect to favorable loan contracts).

[10] 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

Chronicle, the taxpayer acquired lists of newspaper subscribers in connection with the acquisition of the tangible assets of a newspaper publishing company. The newspaper of the acquired publishing company was not published after the acquisition. The court held that depreciation deductions are allowed with respect to an intangible asset if the taxpayer establishes that (1) the intangible asset has an ascertainable value that is separate and distinct from goodwill and (2) the intangible asset has a limited useful life, the duration of which can be ascertained with reasonable accuracy. A jury verdict finding that the taxpayer had satisfied these requirements was thus permitted to stand.

Following the decision in *Houston Chronicle*, the IRS issued Rev. Rul. 74-456.[11] The ruling stated that, in general, customer lists and certain similar items represent the customer structure of a business and are in the nature of goodwill. However, the ruling also stated that, if, in an unusual case, an intangible asset or a portion thereof does not possess the characteristics of goodwill, is susceptible of valuation, and is of use to the taxpayer in its trade or business for only a limited period of time, a depreciation deduction is allowable. The ruling cited the *Houston Chronicle* case and other cases.

Notwithstanding the abandonment of an absolute mass-asset theory by the IRS as evidenced by the issuance of Rev. Rul. 74-456, litigation concerning the treatment of customer-based intangibles has continued as a matter of facts and circumstances, with some courts holding for taxpayers by allowing depreciation or amortization deductions with respect to certain types of customer-based intangibles and other courts holding for the IRS by denying depreciation or amortization deductions with respect to the same types of customer-based intangibles.

For example, in *Donrey, Inc. v. United States*,[12] the Eighth Circuit Court of Appeals held that a subscription list that was acquired in connection with the purchase of the assets of a newspaper publishing company was amortizable if the taxpayer established a value for the subscription list that was separate and distinct from goodwill and the taxpayer established a useful life for the subscription list.[13] A jury verdict finding that these facts had been established was allowed to stand.[14]

However, in *Newark Morning Ledger Co. v. United States*,[15] the Third Circuit Court of Appeals, reversing a district court decision, held that subscription lists acquired in connection with the acquisition of the assets of a newspaper publishing company were not depreciable. The circuit court concluded that the district court had applied an improper definition of goodwill and that the decision of the district court in concluding that the taxpayer had proven a

[11] 1974-2 C.B. 65.

[12] 809 F.2d 534 (8th Cir. 1987).

[13] See, also, *Panichi v. United States*, 834 F.2d 300 (2nd Cir. 1987) (depreciation deductions allowed with respect to list of trash collection customers).

[14] It is interesting to note that, unlike the *Houston Chronicle* case, the newspaper of the acquired publishing company continued to be published by the acquirer.

[15] 945 F.2d 555 (3rd Cir. 1991) *cert. granted*, April 6, 1992.

value separate and apart from goodwill was clearly erroneous.[16] The circuit court stated that "we believe that the Service is correct in asserting that, for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." [17] It further stated that "customer lists are generally not depreciable when acquired in conjunction with the sale of the underlying business as a going concern." [18]

As another example of conflicting court decisions involving apparently similar assets, several courts have considered the Federal income tax treatment of the costs of acquiring insurance expirations, which are the records maintained by insurance agents with respect to insurance customers and which generally include such information as the type of insurance, the amount of insurance, and the expiration date of the insurance.[19] In *Richard S. Miller & Sons, Inc. v. United States*,[20] the taxpayer was allowed depreciation deductions with respect to the portion of the purchase price of an insurance agency that was allocable to insurance expirations.[21] On the other hand, in *Decker v. Commissioner*,[22] the Seventh Circuit Court of Appeals affirmed a Tax Court decision that denied depreciation deductions with respect to insurance expirations that were acquired in connection with the purchase of an insurance agency. The Tax Court held that the insurance expirations were inextricably linked to goodwill principally due to the fact that the purchaser continued the operation of the acquired insurance agency with little change.[23]

Similar inconsistent results have occurred with respect to the treatment of "core deposits," which generally include the checking account, savings account and other similar deposits of a bank that may be withdrawn at will by depositors. In *AmSouth Bancorporation v. United States*,[24] a district court held that although the deposits themselves were identifiable, any value created by the expectation that they would continue was not a value separate and distinct from goodwill and, consequently, no depreciation or amortization deductions were allowed. On the other hand, in *Citizens & Southern Corp. v. Commissioner*,[25] *Colorado National Bankshares,*

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[16] The circuit court observed that the taxpayer's value was determined by reference to the expected income from future patronage of the customers on the list, rather than by reference to the estimated cost of replacing the customer list. Although the court did not hold that the latter valuation method would necessarily have been sustained, it observed that the method used created a value not distinguishable from goodwill.

[17] 945 F.2d 555, 567 (3rd Cir. 1991).

[18] *Id.*

[19] Insurance expirations are valuable to an insurance agency because they enable the agency to contact each policyholder at or near the expiration of the insurance coverage with full knowledge of the type, terms, and history of the existing coverage.

[20] 537 F.2d 446 (Ct. Cl. 1976).

[21] See, also, *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223 (1975) (acq.) (depreciation deductions allowed with respect to credit information files); and *Los Angeles Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269 (1977) (depreciation deductions allowed with respect to medical records of a veterinary hospital).

[22] 864 F.2d 51 (7th Cir. 1988), *aff'g* 54 T.C.M. 338 (1987).

[23] 54 T.C.M. 338 (1987) *aff'd* 864 F.2d 51 (7th Cir. 1988).

[24] 681 F. Supp. 698 (N.D. Ala. 1988).

[25] 91 T.C. 463 (1988), *aff'd* 900 F.2d 266 (11th Cir. 1990).

Inc. v. Commissioner,[26] and *IT&S of Iowa v. Commissioner,*[26a] the Tax Court allowed depreciation deductions with respect to core deposits because the taxpayer established that the core deposits had an ascertainable value that was separate and distinct from goodwill and the core deposits had a limited useful life that could be determined with reasonable accuracy.

On January 30, 1990, the IRS issued an Industry Specialization Program coordinated issue paper that discusses the depreciation of customer-based intangibles. The paper concludes that if an ongoing business is acquired with the expectation of continued patronage of the seller's customers such that the purchaser merely steps into the shoes of the seller and the business possesses characteristics of goodwill, then any customer-based intangible acquired in connection with such purchase is inseparable from goodwill and, thus, is not amortizable as a matter of law.

Treatment of certain workforce-based intangibles

Taxpayers that have acquired an ongoing trade or business have also allocated a portion of the purchase price to assets such as agency force, assembled workforce, or other similar workforce-based intangibles. These intangible assets are generally said to represent the value of having a trained, experienced workforce in place as of the date of acquisition (as opposed to having to hire and train a workforce). Unlike customer-based intangibles, the Federal income tax treatment of workforce-based intangibles has not yet resulted in many court decisions.[27] According to a recent report issued by the General Accounting Office (GAO),[28] however, for the 1979 through 1987 taxable years, the IRS proposed income tax adjustments of $866 million with respect to workforce-based intangibles.

On January 30, 1990, the IRS issued an Industry Specialization Program coordinated issue paper which stated that "any value associated with having a trained staff of employees in place represents the going concern value of an acquired business" and, consequently, the portion of the purchase price of an acquired trade or business that is allocable to the trained workforce is not amortizable. This position of the IRS was recently upheld by the Tax Court in *Ithaca Industries, Inc. v. Commissioner.*[29] In *Ithaca Industries,* the taxpayer allocated $7.7 million of a total purchase price of $160 million to the assembled workforce of an underwear manufacturer. The Tax Court held that the assembled workforce of the taxpayer's

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[26] 60 T.C.M. 771 (1990).

[26a] 97 T.C. 496 (1991).

[27] Taxpayers generally have been allowed depreciation deductions with respect to employment contracts. See, e.g., Rev. Rul. 67-379, 1967-2 C.B. 127 (professional baseball player contracts depreciable); Rev. Rul. 71-137, 1971-1 C.B. 104 (professional football player contracts depreciable); and *KFOX, Inc. v. United States,* 510 F.2d 1365 (Ct. Cl. 1975) (radio disc jockey contracts depreciable). But, see, *National Service Industries, Inc. v. United States* 379 F. Supp. 831 (N.D. Ga. 1973) (employee contracts not depreciable in absence of proof of value or useful lives); *Forman, Inc. v. United States,* 89-1 U.S.T.C. Par. 9165 (D.Md. 1989) ("advantageous" union contract not depreciable); and *The Barnes Group, Inc. v. United States,* 872 F.2d 528 (2nd Cir. 1989) (no allocation of purchase price allowed to employment contracts entered into in contemplation of, and dependent upon, acquisition).

[28] *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets,* Report to the Joint Committee on Taxation by the General Government Division of the General Accounting Office (GAO/GGD-91-88), August 19, 1991 (hereinafter referred to as the GAO Report), p. 4.

[29] 97 T.C. 253 (1991).

trade or business was not a wasting asset separate and distinct from going concern value and, consequently, the portion of the purchase price allocable to the assembled workforce was not amortizable for Federal income tax purposes.

Treatment of government rights of an indefinite duration

Taxpayers generally have not been allowed depreciation or amortization deductions with respect to renewable rights that are granted by a governmental entity because a useful life for the rights generally is not determinable with reasonable accuracy. For example, in *KWTX Broadcasting Co. v. Commissioner*,[30] the Tax Court denied depreciation deductions with respect to a 3-year license issued by the Federal Communications Commission (FCC) to operate a television broadcasting station. The court's holding was based on the fact that the FCC had never refused to renew a license, and, consequently, the license was considered to be of an indefinite duration.[31]

In addition, in *Nachman v. Commissioner*,[32] the Fifth Circuit Court of Appeals denied depreciation deductions with respect to the premium paid for a retail liquor license that was valid for only 5 months after the date of acquisition. The court held that the useful life of the liquor license was likely to continue indefinitely because it was the established practice in issuing renewal licenses to favor the holders of existing licenses over other applicants.[33] Similarly, in *Toledo TV Cable Co. v. Commissioner*,[34] the taxpayer was not allowed depreciation deductions with respect to cable television franchises granted by a governmental entity because the taxpayer failed to establish that the franchises had a determinable useful life.

On the other hand, in *Chronicle Publishing Co. v. Commissioner*,[35] the taxpayer was allowed depreciation deductions with respect to cable television franchises because the taxpayer was able to establish useful lives for the franchises that were determinable with reasonable accuracy. In *Chronicle Publishing Co.*, the franchises did not contain renewal options or other renewal provisions and no practice or custom of granting renewals had been established.

In contrast to cases where the amortization of government contract rights has been disallowed under section 167 of the Code, the Tax Court has recently allowed amortization of these rights under

[30] 31 T.C. 952 (1959), *aff'd per curiam*, 272 F.2d 406 (5th Cir. 1959).

[31] See, also, *Richmond Television Corp. v. United States*, 354 F.2d 410 (4th Cir. 1965), *vacated and remanded on other grounds*, 382 U.S. 68 (1965) (depreciation deductions not allowed with respect to cost of training personnel for a new television station because FCC license had an indefinite useful life); Rev. Rul. 56-520, 1956-2 C.B. 170 (depreciation deductions not allowed with respect to cost of FCC license to operate a television broadcasting station); and Rev. Rul. 64-124, 1964-1 (Part 1) C.B. 105 (same). But, see, *Jefferson-Pilot Corp. v. Commissioner*, 98 T.C. No. 32 (April 13, 1992) (FCC radio broadcast license constitutes a franchise and, consequently, the portion of the purchase price of an acquired radio station that is attributable to the FCC license is amortizable under section 1253 of the Code).

[32] 191 F.2d 934 (5th Cir. 1951).

[33] See, also, *Shufflebarger v. Commissioner*, 24 T.C. 980 (1955) (depreciation deductions not allowed with respect to grazing privileges because the taxpayer was unable to establish a useful life due to a preferential right to renew such privileges); and *Uecker v. Commissioner*, 81 T.C. 983 (1983), *aff'd per curiam*, 766 F.2d 909 (5th Cir. 1985) (same).

[34] 55 T.C. 1107 (1971), *aff'd per curiam*, 483 F.2d 1398 (9th Cir. 1973).

[35] 67 T.C. 964 (1977), *nonacq.* 1980-1 C.B. 2.

section 1253 of the Code. In *Tele-Communications, Inc. v. Commissioner*,[36] the taxpayer asserted in the course of the examination of the taxpayer's income tax return that the rights to operate a cable television system that were granted by a local governmental unit should constitute a franchise for purposes of section 1253 and, thus, should be eligible for the special cost recovery rules under section 1253. The Tax Court concluded that section 1253 applied to the cable television rights, and, consequently, the taxpayer was allowed amortization deductions with respect to the cost of acquiring the cable television rights from the prior operator of the cable television system, even though the rights may extend for an indefinite period. Similarly, the Tax Court in *Jefferson-Pilot Corp. v. Commissioner* [36a] held that an FCC radio broadcasting license was amortizable under section 1253.

Treatment of franchises, trademarks, and trade names

Apart from the application of section 1253, various cases have held that the cost of acquiring a franchise, trademark, or trade name was not depreciable or amortizable because the taxpayer was unable to establish that (1) the franchise, trademark, or trade name was distinguishable from goodwill or (2) the franchise, trademark, or trade name had a limited useful life that was determinable with reasonable accuracy.

For example, in *Clark Thread Co. v. Commissioner*,[37] the court denied a deduction for the cost of securing a competitor's agreement to discontinue the use of a trade name based on the court's conclusion that trade names are like goodwill in their economic characteristics and effect. The court stated that goodwill and trade names may vary in value through the years but will be of ongoing usefulness indefinitely. As a further example, in *Dunn v. United States*,[38] the Tenth Circuit Court of Appeals held that various payments made in connection with a "Dairy Queen" franchise were not amortizable because the taxpayer failed to establish a useful life for the franchise agreement.

In cases where a useful life has been established with reasonable accuracy, depreciation deductions have been allowed with respect to a franchise. For example, in *Chronicle Publishing Co. v. Commissioner*,[39] depreciation deductions were allowed with respect to cable television franchises because the taxpayer established useful lives for the franchises.[40]

Section 1253 provides special rules with respect to payments made on account of certain transfers of a franchise, trademark, or trade name. Under section 167, the acquirer of a franchise, trademark or trade name generally may amortize the cost of acquiring such an asset over the useful life of the asset if a useful life may be established with reasonable accuracy. However, under section 1253,

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[36] 95 T.C. 495 (1990), appeal filed with the Tenth Circuit Court of Appeals.
[36a] 98 T.C. No. 32 (April 13, 1992).
[37] 100 F.2d 257 (3rd Cir. 1939).
[38] 400 F.2d 679 (10th Cir. 1969).
[39] 67 T.C. 964 (1977), *nonacq.* 1980-1 C.B. 2.
[40] Compare, *Toledo TV Cable Co. v. Commissioner*, 55 T.C. 1107 (1971), *aff'd per curiam*, 483 F.2d 1398 (9th Cir. 1973) (depreciation deductions not allowed with respect to cable television franchises because the taxpayer was unable to establish that franchises had determinable useful lives.)

taxpayers may elect under certain circumstances to amortize the cost of acquiring a franchise, trademark, or trade name over 25 years (even if a useful life cannot be established). In addition, an amortization period equal to the shorter of 10 years (rather than 25 years) or the term of the transfer agreement is provided for certain small transactions (i.e., those transactions involving fixed-sum amounts that do not exceed $100,000).[41]

Although the 25-year and 10-year periods of section 1253 do not explicitly apply to a franchise that is sold by one franchisee to another in a transaction that would be eligible for capital gains treatment,[42] the IRS ruled in Rev. Rul. 88-24 [43] that section 1253 applies in such a case if the franchisor retains a significant power, right, or continuing interest with respect to the subject matter of the franchise. Accordingly, if a franchise under which the franchisor retains such rights is sold by one franchisee to another, the portion of the purchase price that is attributable to the franchise is generally amortizable over the lesser of 25 years or the useful life, if a shorter life can be established with reasonable accuracy.

In addition, under section 1253, an ordinary and necessary business expense deduction is allowed for any amount that is contingent on the productivity, use, or disposition of a franchise, trademark, or trade name if the amount is paid as part of a series of payments that (1) are payable at least annually throughout the term of the transfer agreement, and (2) are substantially equal in amount or are payable under a fixed formula.

Disputes have arisen regarding what assets may properly be considered "franchises" within the meaning of section 1253 and, thus, be entitled to the favorable 25-year (or 10-year) amortization election that applies in the absence of an ascertainable useful life. The IRS has contended, for example, that governmental rights cannot qualify as franchises for this purpose. The Tax Court has rejected this argument in *Tele-Communications, Inc. v. Commissioner* [44] and *Jefferson-Pilot Corp. v. Commissioner*.[45] Disputes also have arisen as to whether particular arrangements between private parties constitute a franchise for purposes of section 1253. For example, the issue whether certain television network affiliation contracts qualify for the cost recovery provisions of section 1253 has been raised in several pending cases.

Finally, disputes have arisen regarding what portion, if any, of the purchase price of an acquired trade or business is properly at-

[41] Prior to the enactment of the Omnibus Budget Reconciliation Act of 1989, a 10-year amortization period, rather than a 25-year period, generally applied to all transactions including those with fixed-sum amounts in excess of $100,000.

[42] The election of a 25-year amortization period applies where the transfer of a franchise, trademark, or trade name is "not ... treated as a sale or exchange of a capital asset" by reason of section 1253(a), which denies such treatment to a transferor "if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name." (Secs. 1253(d)(2) and (3), 1253(a).)

[43] 1988-1 C.B. 306.

[44] 95 T.C. 495 (1990) (rights to operate a cable television system constitute a franchise for purposes of section 1253), appeal filed with the Tenth Circuit Court of Appeals.

[45] 98 T.C. No. 32 (April 13, 1992) (FCC radio broadcast license constitutes a franchise for purposes of section 1253).

tributable to the "franchise" as distinct from some other going concern element of a franchised business.[46]

Treatment of covenants not to compete

As part of the sale of a trade or business, the purchaser and seller often enter into an agreement frequently stated to be for some fixed time period pursuant to which the seller agrees not to compete with the trade or business acquired by the purchaser. As in the case of other intangible assets, depreciation deductions are allowed with respect to a covenant not to compete only if the covenant is distinguishable from goodwill and the covenant has a useful life that is determinable with reasonable accuracy.

The issues of (1) whether a covenant not to compete is depreciable for Federal income tax purposes and (2) what portion of the purchase price of an acquired trade or business is allocable to a covenant not to compete have been the subject of numerous disputes between taxpayers and the IRS. In many cases, the purchaser and the seller have not assigned any purchase price to the covenant not to compete. The courts generally have not allowed depreciation deductions with respect to a covenant not to compete if no portion of the purchase price has been specifically assigned to the covenant.[47] If, on the other hand, the amount paid for a covenant not to compete has been separately bargained for and has a basis in economic reality, the courts have generally respected the purchase price allocation, particularly where the parties have had adverse tax interests with respect to the allocation.[48]

Prior to the enactment of the Tax Reform Act of 1986, the seller and the purchaser of a trade or business generally had significant adverse interests with respect to the allocation of purchase price to a covenant not to compete. First, the tax rate that applied to long-term capital gains was significantly lower than the rate that applied to ordinary income. In addition, corporate-level capital gain was generally tax-free under the rules relating to corporate liquidations. The adversity arose under prior law because the amount received by a seller under a covenant not to compete generally was treated as ordinary income, while the remaining amount of the purchase price was generally treated as capital gain. For the purchaser, the amount paid for the covenant not to compete generally was amortizable over the relatively short term of the covenant,

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[46] See, e.g., *Tele-Communications, Inc. v. Commissioner*, 95 T.C. 495 (1990) (Tax Court agreed with one of taxpayer's two experts regarding the amount properly allocable to going concern value or some other nonamortizable asset distinct from a franchise); and *Nachman v. Commissioner*, 191 F.2d 934 (5th Cir. 1951).

[47] See, e.g., *Delsea Drive-In Theatres, Inc. v. Commissioner*, 379 F.2d 316 (3rd Cir. 1967); and *General Insurance Agency, Inc. v. Commissioner*, 401 F.2d 324 (4th Cir. 1968). See, also, *Forward Communications Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979), in which it was stated as a fact that a 5-year period for a covenant was chosen because the taxpayer felt that after that period the seller would lose its effectiveness in the relevant market. The court concluded that the covenant was not a separable wasting asset, but merely protective of the goodwill that the taxpayer acquired in the purchase.

[48] See, e.g., *Christensen Machine Co. v. Commissioner*, 18 B.T.A. 256 (1929); *Commissioner v. Gazette Telegraph Co.*, 209 F.2d 926 (10th Cir. 1954); and *United Elchem Industries, Inc. v. Commissioner*, 42 T.C.M. 460 (1981). See, also, *Ullman v. Commissioner*, 264 F.2d 305 (2nd Cir. 1959); and *Commissioner v. Danielson*, 378 F.2d 771 (3rd Cir. 1967), *cert. denied*, 389 U.S. 858. Section 1060(a) of the Code, as amended by the Omnibus Budget Reconciliation Act of 1990, forbids parties who agree in writing as to the allocation of purchase price to challenge the allocation unless certain standards of the *Danielson* case are satisfied. The IRS, however, may challenge the allocation.

while the remaining amount of the purchase price was allocated to longer-lived depreciable assets or to nondepreciable assets.

Under present law, the purchaser of a trade or business continues to have an incentive to allocate purchase price to a covenant not to compete. With the elimination of the preference for long-term capital gains and the repeal of the tax-free treatment of corporate-level capital gain, however, the seller of a trade or business no longer has a significant adverse interest. Anecdotal evidence from some taxpayers and practitioners suggests that the amount of the purchase price of an acquired trade or business that is allocated to a covenant not to compete may have increased in some situations since the enactment of the Tax Reform Act of 1986.

Treatment of patents and copyrights

The Treasury Department regulations relating to the depreciation of intangible property provide that patents and copyrights are types of intangible property with respect to which depreciation deductions are allowed for Federal income tax purposes.[49] The legal life of a patent issued by the United States Patent Office is 17 years, while the legal life of a copyright generally extends for the life of the author plus 50 years. The cost of acquiring a patent or copyright, however, need not be amortized over the remaining legal life of the patent or copyright as of the date of acquisition. Instead, a taxpayer may establish that the useful life of the patent or copyright is shorter than the legal life, in which case the cost of the patent or copyright would be recovered over such shorter period. If the purchase price of a patent is payable on an annual basis as a fixed percentage of the revenue derived from the use of the patent, the amount of depreciation allowed for any taxable year with respect to the patent generally equals the amount of the royalty paid or incurred during such year.[50]

Treatment of contracts with a stated life

A taxpayer that acquires the assets of a trade or business will often acquire rights under contracts that were entered into by the seller of the trade or business with third parties.[51] For example, the buyer may step into the shoes of the seller with respect to a supply contract that grants the buyer more favorable terms than the buyer could obtain on its own with respect to the subject matter of the contract.[52] The portion of the purchase price of an

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[49] Treas. Reg. sec. 1.167(a)-3.

[50] See, e.g., *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945) (acq.); *Newton Insert Co. v. Commissioner*, 61 T.C. 570 (1974), *aff'd per curiam*, 545 F.2d 1259 (9th Cir. 1976); and Rev. Rul. 67-136, 1967-1 C.B. 58.

[51] In addition, a taxpayer may incur costs in connection with entering into a contract. These costs generally must be capitalized and amortized over the life of the contract. For example, Treasury regulation section 1.162-11 and section 178 of the Code generally provide that costs incurred to acquire a leasehold interest must be capitalized and amortized over the term of the lease, in certain cases taking into account renewal options.

[52] Taxpayers also have assigned valued to, and claimed amortization deductions with respect to, contracts for which the taxpayer provides goods or services to third parties. Some courts have allowed amortization deductions with respect to these customer-based contracts, while others have held such contracts to be analogous to goodwill. Compare *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966) (amortization deductions allowed with respect to consumer term loans) with *U.S. Industrial Alcohol Co. v. Commissioner*, 137 F.2d 511 (2nd Cir. 1943) (amortization deductions not allowed with respect to contracts to supply products to customers because such contracts were akin to goodwill). For a discussion of customer-based intangibles, see above.

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acquired trade or business that is assigned to a favorable contract may be amortized for Federal income tax purposes if the buyer establishes that (1) the contract has a limited useful life, the duration of which can be established with reasonable accuracy, and (2) the contract has an ascertainable value that is separate and distinct from goodwill.[53]

Taxpayers have successfully demonstrated that contracts to acquire supplies at a specific price are separate and distinct from goodwill or going concern value even though the supplies that are the subject of the contract were essential to the operation of the taxpayers' trade or business.[54] However, taxpayers have had mixed results in demonstrating that acquired contracts had limited useful lives, particularly where the contracts are renewable. The probability of future renewals generally is a question of fact.[55]

For example, in *Westinghouse Broadcasting Corp. v. Commissioner*,[56] the Third Circuit Court of Appeals held that a television network affiliation contract that had a term of two years, but was automatically renewable an indefinite number of times, had an indefinite life and was not subject to amortization. As a further example, in *Forward Communications Corp. v. United States*,[57] the Court of Claims held that amounts allocated to advertising contracts acquired in the purchase of a television station could not be deducted over the stated period of the contracts because of difficulties of identifying values and because of the likelihood that the contracts might be renewed. Similarly, in *ThriftiCheck Service Corporation v. Commissioner*, the Second Circuit Court of Appeals held that amounts allocated to 200 customer contracts of an acquired business were not amortizable. A reasonable determination of the life of any benefits provided by the contracts could not be made, given the combination of provisions for cancellation and automatic renewal in the contracts and the history and prospect of continuing relations with the customers beyond the initial term and first renewal period in the contracts.[58]

On the other hand, in *Ithaca Industries, Inc. v. Commissioner*,[59] the Tax Court recently decided that the cost of acquiring contracts that allowed the taxpayer to purchase raw materials at a price below the current market price may be amortized for Federal income tax purposes. The court found that the contracts were not automatically renewable, and any contract renewal would likely be distinguishable from the original existing contract. In addition, the fact that the parties could modify certain terms of the contracts during the period covered by the contracts did not cause the contracts to be indefinite in length.

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[53] *Southern Bancorporation, Inc. v. Commissioner*, 847 F.2d 131, 136-137 (4th Cir. 1988).

[54] See, e.g., *Triangle Publications, Inc. v. Commissioner*, 54 T.C. 138 (1970); and *Ithaca Industries, Inc. v. Commissioner*, 97 T.C. 253 (1991).

[55] *Toledo TV Cable Co. v. Commissioner*, 55 T.C. 1107, 1117 (1971), *aff'd. per curiam*, 483 F.2d 1398 (9th Cir. 1973).

[56] 309 F.2d 279 (3rd Cir. 1962), *cert. denied*, 372 U.S. 935.

[57] 608 F.2d 485 (Ct. Cl. 1979).

[58] 278 F.2d 1, (2nd Cir. 1961), *aff'g* 33 T.C. 1038 (1960). Compare, *Seaboard Finance Co. v. Commissioner*, 367 F.2d 646 (9th Cir. 1966).

[59] 97 T.C. 253 (1991).

General issues regarding valuation of intangible assets

In addition to issues regarding the identification of separate intangible assets, issues frequently arise regarding the valuation of intangible assets. These issues may be closely related to, or even determinative of, whether an asset has been identified that is separate and distinct from goodwill. Alternatively, these issues may arise in situations where the existence of a separate asset has been acknowledged.

Present law contains very broad rules regarding the allocation of purchase price among the assets of an acquired trade or business. These rules do not provide a method other than a facts and circumstances test for allocating purchase price among different assets, including the allocation of purchase price among different amortizable or depreciable assets.

In general, under the present-law allocation rules, if a business is acquired, purchase price must be allocated first to cash and certain cash equivalents, second to marketable securities and certain other similar items, third to all assets (tangible or intangible) not in another category, and, fourth to nondepreciable goodwill or going concern value.[60]

Prior to the adoption of the present-law rules, goodwill and going concern value were not explicitly required to be considered a "residual" category. Rather, some taxpayers would separately identify an initial value for such assets along with values for all other assets. In cases where taxpayers contended that they had paid a "premium" price, (i.e., an amount greater than the value of all the assets), some taxpayers interpreted the law to permit allocating this residual amount proportionately among all assets, with the result that the depreciable value of some assets would exceed their identified fair market value.

Present law expressly requires any excess purchase price over the identified fair market value of cash equivalents, marketable securities, and depreciable assets to be allocated entirely to nondepreciable goodwill or going concern value. However, present law does not generally provide any statutory limits on the extent to which purchase price may be allocated to amortizable assets rather than to nonamortizable goodwill or going concern value.[61] Present law also does not provide a method for allocating purchase price among amortizable assets. Thus, disputes often arise under present law over whether the value of particular amortizable assets are "overstated" or "understated." Present law also does not provide rules other than facts and circumstances for determining whether the taxpayer has made a "premium" purchase (with resulting nonamortizable goodwill or going concern value) or a "bargain" purchase (in which case some taxpayers may argue that they obtained amortizable assets for less than fair market value and, under the

[60] Section 1060 of the Code for asset acquisitions; and Temp. and Prop. Reg. sec. 1.338(b)-2T under section 338(b)(5) for stock acquisitions treated as asset acquisitions under a taxpayer election. The allocation rules differ in some respects depending upon whether the section 1060 or section 338 rules apply.

[61] Section 1056 of the Code creates a presumption that no more than 50 percent of the purchase price of acquiring a professional sports franchise is allocable to amortizable player contracts.

priority allocation rules, are thus entitled to allocate virtually nothing to goodwill or going concern value).

Present law contains reporting rules that require the buyer and seller of certain assets to report the values allocated to various assets or categories of assets (sec. 1060(b) and regulations). Present law does not contain an explicit penalty that applies if the buyer and seller do not allocate the same amounts to the same assets. However, if, in connection with an acquisition, the transferor and transferee agree in writing as to the allocation of any consideration or the fair market value of any assets, neither of the parties may thereafter challenge the allocation unless the Secretary of the Treasury determines the allocation is not appropriate (sec. 1060(a)). Reporting is also required, as prescribed by Treasury Department regulations, if, in connection with the transfer of certain interests in an entity, there is also a covenant not to compete or other agreement with the transferee (sec. 1060(e)).

Taxpayers have used different methods to value intangible assets. Such methods include a replacement cost approach ("cost"), a comparable transactions (or "market") approach (if there is a comparable intangible that is sold between unrelated parties), and an approach based on the allocation of a portion of estimated future earnings to a particular intangible and discounting such earnings to their present value ("future earnings"). With respect to a single business acquisition, some intangibles may be valued by one method and others by another. In addition, different acquirers may use different methods to value similar types of intangibles.

Disputes may arise over any aspect of the allocation, including whether a particular asset should properly be valued based on cost, on market, or on future earnings. If a cost method is used, there may be disputes regarding how that cost is determined and what expenses should be taken into account in determining the cost. If a market approach is used, there may be disputes regarding whether there are in fact comparable arm's length transactions. If an earnings method is used, there may be disputes regarding what portion of future earnings should be allocated to one intangible rather than to another, the time period over which the earnings should be estimated, and what discount rate should be used to determine present value.

In litigation, taxpayers and the IRS typically produce expert testimony regarding the valuation of particular assets. Frequently, the experts disagree about particular valuations. Moreover, the several experts for one party may not be in complete agreement regarding valuations.

Comparison of present-law treatment of tangible property

The rules governing the depreciation or amortization of intangible property differ from the rules governing the depreciation of tangible property, which have evolved over many years. Under the present-law rules applicable to tangible property, specific lives are assigned to specific types of depreciable property. The experience of a particular business enterprise or a particular taxpayer with respect to an asset generally is not relevant.

Originally, the tangible property depreciation rules were similar to the present-law rules governing intangibles. Tangible property

depreciation was determined based on the facts and circumstances of each case. The rules later evolved to permit the use of guideline lives without precluding taxpayers from showing a shorter life. In the past decade, the use of specified lives became mandatory for tangible assets.[62] Issues may still arise regarding the allocation of purchase price among tangible assets (for example, between a building, which is depreciable, and land, which is not). However, the adoption of specified lives and methods generally has eliminated disputes concerning the depreciation of tangible property, regardless of whether such lives and methods corresponds to any taxpayer's actual experience.

Treatment of self-created assets

Taxpayers are allowed a deduction for all the ordinary and necessary expenses that are paid or incurred during a taxable year in carrying on any trade or business (sec. 162(a)). However, taxpayers generally may not deduct currently the costs of acquiring, permanently improving, or increasing the value of any property (sec. 263(a)). These costs generally must be capitalized.[63] In addition, the direct and indirect costs of a taxpayer that are allocable to property that is acquired by the taxpayer for resale or that are allocable to certain real or tangible personal property produced by the taxpayer must be included in inventory or capitalized (sec. 263A).[64]

Costs that are paid or incurred to acquire an intangible asset generally must be capitalized. However, some costs that are paid or incurred to create, maintain, or enhance the value of certain intangible assets may be deducted as ordinary and necessary business expenses for the year that the costs are paid or incurred.[65] For example, advertising expenses generally may be deducted for the year that the expenses are paid or incurred even though the advertising often results in income in future taxable years.[66] Likewise, costs incurred to train employees generally may be deducted for the year that the costs are paid or incurred even though the training results in a more knowledgeable or valuable workforce.[67] Thus, although taxpayers generally must capitalize the costs of acquiring intangible assets from another person (such as the costs of acquiring a customer list or goodwill), taxpayers generally may currently deduct the costs incurred to develop or maintain such intangible assets.

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[62] For a more extensive discussion of the history of tangible asset depreciation, see the GAO Report, n. 26, pp. 16-18. In the case of tangible property, the specified lives often were designed to contain an incentive accelerated depreciation element.

[63] See, e.g., *American Seating Co. v. Commissioner*, 4 B.T.A. 1588 (1926) (amounts paid for exclusive licenses for use of designs and inventions must be capitalized); *KWTX Broadcasting Company, Inc. v. Commissioner*, 31 T.C. 952 (1959), *aff'd per curiam*, 272 F.2d 406 (5th Cir. 1959) (costs incurred to obtain a television construction permit and broadcasting licenses were capital expenditures); and *Manhattan Co. of Virginia, Inc. v. Commissioner*, 50 T.C. 78 (1968) (a customer list purchased by a laundry was an intangible asset, the cost of which must be capitalized).

[64] For this purpose, the term "tangible personal property" includes a film, sound recording, video tape, book or similar property.

[65] Section 174 of the Code also permits the immediate deduction of research and experimental costs that contribute to the creation of intangibles such as technology and similar items. However, a taxpayer who purchases such intangibles from another taxpayer must capitalize the price paid and amortize it over the useful life of the asset if one can be established.

[66] See, e.g., Treas. Reg. sec. 1.162-20(a)(2).

[67] See, e.g., *Knoxville Iron Co. v. Commissioner*, 18 T.C.M. 251 (1959) (training costs held to be deductible when incurred); and *Cleveland Electric Illuminating Co. v. Commissioner*, 7 Cl. Ct. 220 (1985) (certain training costs were deductible when incurred; other training costs required to be capitalized because the costs related to the start-up of a new business).

III. DESCRIPTION OF PROPOSALS

A. Section 4501 of H.R. 4210 [68]

Overview

Section 4501 of H.R. 4210 would allow an amortization deduction with respect to the capitalized costs of certain intangible property (defined as a "section 197 intangible") that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction would be determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible ratably over a 14-year period that begins with the month that the intangible is acquired.[69] No other depreciation or amortization deduction would be allowed with respect to a section 197 intangible that is acquired by a taxpayer.

In general, the bill would apply to a section 197 intangible acquired by a taxpayer regardless of whether it is acquired as part of a trade or business. In addition, the bill generally would apply to a section 197 intangible that is treated as acquired under section 338 of the Code. The bill generally would not apply to a section 197 intangible that is created by the taxpayer if the intangible is not created in connection with a transaction (or series of related transactions) that involves the acquisition of a trade or business or a substantial portion thereof.

Except in the case of amounts paid or incurred under certain covenants not to compete (or under certain other arrangements that have substantially the same effect as covenants not to compete) and certain amounts paid or incurred on account of the transfer of a franchise, trademark, or trade name, the bill generally would not apply to any amount that is otherwise currently deductible (*i.e.*, not capitalized) under present law.

Definition of section 197 intangible

In general

The term "section 197 intangible" would be defined as any property that is included in any one or more of the following categories: (1) goodwill and going concern value; (2) certain specified types of intangible property that generally relate to workforce, information base, know-how, customers, suppliers, or other similar items; (3) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof; (4) any covenant not to

[68] H.R. 4210, the "Tax Fairness and Economic Growth Act of 1992," was passed by Congress on March 20, 1992, and was vetoed by the President.

[69] In the case of a short taxable year, the amortization deduction would be based on the number of months in such taxable year.

compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (5) any franchise, trademark, or trade name.

Certain types of property, however, would be specifically excluded from the definition of the term "section 197 intangible." The term "section 197 intangible" would not include: (1) any interest in a corporation, partnership, trust, or estate; (2) any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract; (3) any interest in land; (4) certain computer software; (5) certain interests in films, sound recordings, video tapes, books, or other similar property; (6) certain rights to receive tangible property or services; (7) certain interests in patents or copyrights; (8) any interest under an existing lease of tangible property; (9) any interest under an existing indebtedness (except for the deposit base and similar items of a financial institution); and (10) a franchise to engage in any professional sport, and any item acquired in connection with such a franchise.

Goodwill and going concern value

For purposes of the bill, goodwill would be defined as the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor.

In addition, for purposes of the bill, going concern value would be defined as the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern. Going concern value would include the value that is attributable to the ability of a trade or business to continue to function and generate income without interruption notwithstanding a change in ownership. Going concern value also would include the value that is attributable to the use or availability of an acquired trade or business (for example, the net earnings that otherwise would not be received during any period were the acquired trade or business not available or operational).

Workforce, information base, know-how, customer-based intangibles, supplier-based intangibles and other similar items

Workforce.—The term "section 197 intangible" would include workforce in place (which is sometimes referred to as agency force or assembled workforce), the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a highly-skilled workforce would be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring an existing employment contract (or contracts) or a relationship with employees or consultants (including but not limited to any "key employee" contract or relationship) as part of the ac-

quisition of a trade or business would be amortized over the 14-year period specified in the bill.

Information base.—The term "section 197 intangible" would include business books and records, operating systems, and any other information base including lists or other information with respect to current or prospective customers (regardless of the method of recording such information). Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems would be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring customer lists, subscription lists, insurance expirations,[70] patient or client files, or lists of newspaper, magazine, radio or television advertisers would be amortized over the 14-year period specified in the bill.

Know-how.—The term "section 197 intangible" would include any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. For this purpose, the term "section 197 intangible" would include package designs, computer software, and any interest in a film, sound recording, video tape, book, or other similar property, except as specifically provided otherwise in the bill.[71]

Customer-based intangibles.—The term "section 197 intangible" would include any customer-based intangible, which would be defined as the composition of market, market share, and any other value resulting from the future provision of goods or services pursuant to relationships with customers (contractual or otherwise) in the ordinary course of business. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of customer base, circulation base, undeveloped market or market growth, insurance in force, mortgage servicing contracts, investment management contracts, or other relationships with customers that involve the future provision of goods or services, would be amortized over the 14-year period specified in the bill. On the other hand, the portion (if any) of the purchase price of an acquired trade or business that is attributable to accounts receivable or other similar rights to income for those goods or services that have been provided to customers prior to the acquisition of a trade or business would not to be taken into account under the bill.[72]

In addition, the bill specifically provides that the term "customer-based intangible" would include the deposit base and any similar asset of a financial institution. Thus, for example, the portion (if any) of the purchase price of an acquired financial institution that is attributable to the checking accounts, savings accounts,

[70] Insurance expirations are records that are maintained by insurance agents with respect to insurance customers. These records generally include information relating to the type of insurance, the amount of insurance, and the expiration date of the insurance.

[71] See below for a description of the exceptions for certain patents, certain computer software, and certain interests in films, sound recordings, video tapes, books, or other similar property.

[72] As under present law, the portion of the purchase price of an acquired trade or business that is attributable to accounts receivable would be allocated among such receivables and would be taken into account as payment is received under each receivable or at the time that a receivable becomes worthless.

escrow accounts and other similar items of the financial institution would be amortized over the 14-year period specified in the bill.

Supplier-based intangibles.—The term "section 197 intangible" would include any supplier-based intangible, which would be defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a favorable relationship with persons that provide distribution services (for example, favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts, would be amortized over the 14-year period specified in the bill.[73]

Other similar items.—The term "section 197 intangible" would also include any other intangible property that is similar to workforce, information base, know-how, customer-based intangibles, or supplier-based intangibles.

Licenses, permits, and other rights granted by governmental units

The term "section 197 intangible" would include any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof (even if the right is granted for an indefinite period or the right is reasonably expected to be renewed for an indefinite period).[74] Thus, for example, the capitalized cost of acquiring from any person a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (which is sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license would be amortized over the 14-year period specified in the bill. For purposes of the bill, the issuance or renewal of a license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof would be considered an acquisition of such license, permit, or other right.

Covenants not to compete and other similar arrangements

The term "section 197 intangible" would include any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete; hereafter "other similar arrangement") entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof). For this purpose, an interest in a trade or business would include not only the assets of a trade or business, but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business.

Any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) entered into in connection

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[73] See below, however, for a description of the exception for certain rights to receive tangible property or services from another person.

[74] A right granted by a governmental unit or an agency or instrumentality thereof that constitutes an interest in land or an interest under a lease of tangible property would be excluded from the definition of a section 197 intangible. See below for a description of the exceptions for interests in land and for interests under leases of tangible property.

with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof) would be chargeable to capital account and would be amortized ratably over the 14-year period specified in the bill. In addition, any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) after the taxable year in which the covenant (or other similar arrangement) was entered into would be amortized ratably over the remaining months in the 14-year amortization period that applies to the covenant (or other similar arrangement) as of the beginning of the month that the amount is paid or incurred.

For purposes of this provision, an arrangement that requires the former owner of an interest in a trade or business to continue to perform services (or to provide property or the use of property) that benefit the trade or business would be considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered (or for the property or use of property actually provided) by the former owner. As under present law, to the extent that the amount paid or incurred under a covenant not to compete (or other similar arrangement) represents additional consideration for the acquisition of stock in a corporation, such amount would not be taken into account under this provision but, instead, would be included as part of the acquirer's basis in the stock.

Franchises, trademarks, and trade names

The term "section 197 intangible" would include any franchise, trademark, or trade name. For this purpose, the term "franchise" would be defined as under present law to include any agreement that provides one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area (sec. 1253(b)(1)). In addition, as provided under present law, the renewal of a franchise, trademark, or trade name would be treated as an acquisition of such franchise, trademark, or trade name.[75]

The bill would continue the present-law treatment of certain contingent amounts that are paid or incurred on account of the transfer of a franchise, trademark, or trade name. Under these rules, a deduction would be allowed for amounts that are contingent on the productivity, use, or disposition of a franchise, trademark, or trade name only if (1) the contingent amounts are paid as part of a series of payments that are payable at least annually throughout the term of the transfer agreement, and (2) the payments are substantially equal in amount or payable under a fixed formula (sec. 1253(d)(1)). Any other amount, whether fixed or contingent, that is paid or incurred on account of the transfer of a franchise, trademark, or trade name would be chargeable to capital account and

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[75] Only the costs incurred in connection with the renewal, however, would be amortized over the 14-year period that begins with the month that the franchise, trademark, or trade name is renewed. Any costs incurred in connection with the issuance (or an earlier renewal) of a franchise, trademark, or trade name would continue to be taken into account over the remaining portion of the amortization period that began at the time of such issuance (or earlier renewal).

would be amortized ratably over the 14-year period specified in the bill.

Exceptions to the definition of a section 197 intangible

In general.—The bill would provide several exceptions to the definition of the term "section 197 intangible." Several of the exceptions contained in the bill would apply only if the intangible property is not acquired in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business. It is anticipated that the Treasury Department would exercise its regulatory authority to require any intangible property that would otherwise be excluded from the definition of the term "section 197 intangible" to be taken into account under the bill under circumstances where the acquisition of the intangible property is, in and of itself, the acquisition of an asset which constitutes a trade or business or a substantial portion of a trade or business.

The determination of whether acquired assets constitute a substantial portion of a trade or business would be based on all of the facts and circumstances, including the nature and the amount of the assets acquired as well as the nature and the amount of the assets retained by the transferor. It is not intended, however, that the value of the assets acquired relative to the value of the assets retained by the transferor would be determinative of whether the acquired assets constitute a substantial portion of a trade or business.

For purposes of the bill, a group of assets would constitute a trade or business if the use of such assets would constitute a trade or business for purposes of section 1060 of the Code (*i.e.*, if the assets are of such a character that goodwill or going concern value could under any circumstances attach to the assets). In addition, the acquisition of a franchise, trademark or trade name would constitute the acquisition of a trade or business or a substantial portion of a trade or business.

In determining whether a taxpayer has acquired an intangible asset in a transaction (or series of related transactions) that involves the acquisition of assets that constitute a trade or business or a substantial portion of a trade or business, only those assets acquired in a transaction (or a series of related transactions) by a taxpayer (and persons related to the taxpayer) from the same person (and any related person) would be taken into account. In addition, any employee relationships that continue (or covenants not to compete that are entered into) as part of the transfer of assets would be taken into account in determining whether the transferred assets constitute a trade or business or a substantial portion of a trade or business.

Interests in a corporation, partnership, trust, or estate.—The term "section 197 intangible" would not include any interest in a corporation, partnership, trust, or estate. Thus, for example, the bill would not apply to the cost of acquiring stock, partnership inter-

ests, or interests in a trust or estate, whether or not such interests are regularly traded on an established market.[76]

Interests under certain financial contracts.—The term "section 197 intangible" would not include any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract, whether or not such interest is regularly traded on an established market. Any interest under a mortgage servicing contract, credit card servicing contract or other contract to service indebtedness issued by another person, and any interest under an assumption reinsurance contract [77] would not be excluded from the definition of the term "section 197 intangible" by reason of the exception for interests under certain financial contracts.

Interests in land.—The term "section 197 intangible" would not include any interest in land. Thus, the cost of acquiring an interest in land would be taken into account under present law rather than under the bill. For this purpose, an interest in land would include a fee interest, life estate, remainder, easement, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, and any other similar rights with respect to land. An interest in land would not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television services.

Certain computer software.—The term "section 197 intangible" would not include computer software (whether acquired as part of a trade or business or otherwise) that (1) is readily available for purchase by the general public; (2) is subject to a non-exclusive license; and (3) has not been substantially modified. In addition, the term "section 197 intangible" would not include computer software which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

For purposes of the bill, the term "computer software" would be defined as any program (*i.e.*, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function. The term "computer software" would include any incidental and ancillary rights with respect to computer software that (1) are necessary to effect the legal acquisition of the title to, and the ownership of, the computer software, and (2) are used only in connection with the computer software. The term "computer software" would not include any data base or other similar item regardless of the form in which it is maintained or stored.

If a depreciation deduction is allowed with respect to any computer software that is not a section 197 intangible, the amount of the deduction would be determined by amortizing the adjusted basis of the computer software ratably over a 36-month period that begins with the month that the computer software is placed in service. For this purpose, the cost of any computer software that is taken into account as part of the cost of computer hardware or

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[76] A temporal interest in property, outright or in trust, could not be used to convert a section 197 intangible into property that is amortizable more rapidly than ratably over the 14-year period specified in the bill.

[77] See below for a description of the treatment of assumption reinsurance contracts.

other tangible property under present law would continue to be taken into account in such manner under the bill. In addition, the cost of any computer software that is currently deductible (*i.e.*, not capitalized) under present law would continue to be taken into account in such manner under the bill.

Certain interests in films, sound recordings, video tapes, books, or other similar property.—The term "section 197 intangible" would not include any interest (including an interest as a licensee) in a film, sound recording, video tape, book, or other similar property if the interest is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

Certain rights to receive tangible property or services.—The term "section 197 intangible" would not include any right to receive tangible property or services under a contract (or any right to receive tangible property or services granted by a governmental unit or an agency or instrumentality thereof) if the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to a right to receive tangible property or services that is not a section 197 intangible, the amount of the deduction would be determined in accordance with regulations to be promulgated by the Treasury Department. It is anticipated that the regulations may provide that in the case of an amortizable right to receive tangible property or services in substantially equal amounts over a fixed period that is not renewable, the cost of acquiring the right will be taken into account ratably over such fixed period. It is also anticipated that the regulations may provide that in the case of a right to receive a fixed amount of tangible property or services over an unspecified period, the cost of acquiring such right will be taken into account under a method that allows a deduction based on the amount of tangible property or services received during a taxable year compared to the total amount of tangible property or services to be received.

For example, assume that a taxpayer acquires from another person a favorable contract right of such person to receive a specified amount of raw materials each month for the next three years (which is the remaining life of the contract) and that the right to receive such raw materials is not acquired as part of the acquisition of assets that constitute a trade or business or a substantial portion thereof (*i.e.*, such contract right is not a section 197 intangible). It is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right ratably over the three-year remaining life of the contract. Alternatively, if the favorable contract right is to receive a specified amount of raw materials during an unspecified period, it is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right by multiplying such cost by a fraction, the numerator of which is the amount of raw materials received under the contract during any taxable year and the denominator of which is the total amount of raw materials to be received under the contract.

It is also anticipated that the regulations may require a taxpayer under appropriate circumstances to amortize the cost of acquiring a renewable right to receive tangible property or services over a period that includes all renewal options exercisable by the taxpayer at less than fair market value.

Certain interests in patents or copyrights.—The term "section 197 intangible" would not include any interest in a patent or copyright which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to an interest in a patent or copyright and the interest is not a section 197 intangible, then the amount of the deduction would be determined in accordance with regulations to be promulgated by the Treasury Department. It is anticipated that the regulations may provide that if the purchase price of a patent is payable on an annual basis as a fixed percentage of the revenue derived from the use of the patent, then the amount of the depreciation deduction allowed for any taxable year with respect to the patent would equal the amount of the royalty paid or incurred during such year.[78]

Interests under leases of tangible property.—The term "section 197 intangible" would not include any interest as a lessor or lessee under an existing lease of tangible property (whether real or personal).[79] The cost of acquiring an interest as a lessor under a lease of tangible property where the interest as lessor is acquired in connection with the acquisition of the tangible property would be taken into account as part of the cost of the tangible property. For example, if a taxpayer acquires a shopping center that is leased to tenants operating retail stores, the portion (if any) of the purchase price of the shopping center that is attributable to the favorable attributes of the leases would be taken into account as a part of the basis of the shopping center and would be taken into account in determining the depreciation deduction allowed with respect to the shopping center.

The cost of acquiring an interest as a lessee under an existing lease of tangible property would be taken into account under present law (see section 178 of the Code and Treas. Reg. sec. 1.162-11(a)) rather than under the provisions of the bill.[80] In the case of any interest as a lessee under a lease of tangible property that is acquired with any other intangible property (either in the same transaction or series of related transactions), however, the portion of the total purchase price that is allocable to the interest as a lessee could not exceed the excess of (1) the present value of the fair market value rent for the use of the tangible property for the term of the lease,[81] over (2) the present value of the rent reason-

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[78] See *Associated Patentees, Inc.*, 4 T.C. 979 (1945); and Rev. Rul. 67-136, 1967-1 C.B. 58.

[79] A sublease would be treated in the same manner as a lease of the underlying property. Thus, the term "section 197 intangible" would not include any interest as a sublessor or sublessee of tangible property.

[80] The lease of a gate at an airport for the purpose of loading and unloading passengers and cargo would be considered a lease of tangible property for this purpose. It is anticipated that such treatment will serve as guidance to the Internal Revenue Service and taxpayers in resolving past disputes.

[81] In no event could the present value of the fair market value rent for the use of the tangible property for the term of the lease exceed the fair market value of the tangible property as of the

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ably expected to be paid for the use of the tangible property for the term of the lease.

Interests under indebtedness.—The term "section 197 intangible" would not include any interest (whether as a creditor or debtor) under any indebtedness that was in existence on the date that the interest was acquired.[82] Thus, for example, the value of assuming an existing indebtedness with a below-market interest rate would be taken into account under present law rather than under the bill. In addition, the premium paid for acquiring the right to receive an above-market rate of interest under a debt instrument may be taken into account under section 171 of the Code, which generally allows the amount of the premium to be amortized on a yield-to-maturity basis over the remaining term of the debt instrument. This exception for interests under existing indebtedness would not apply to the deposit base and other similar items of a financial institution.

Professional sports franchises.—The term "section 197 intangible" would not include a franchise to engage in professional baseball, basketball, football, or other professional sport, and any item acquired in connection with such a franchise. Consequently, the cost of acquiring a professional sports franchise and related assets (including any goodwill, going concern value, or other section 197 intangibles) would be allocated among the assets acquired as provided under present law (see, for example, section 1056 of the Code) and would be taken into account under the provisions of present law.

Exception for certain self-created intangibles

The bill generally would not apply to any section 197 intangible that is created by the taxpayer if the section 197 intangible is not created in connection with a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion thereof.

For purposes of this exception, a section 197 intangible that is owned by a taxpayer would be considered created by the taxpayer if the intangible is produced for the taxpayer by another person under a contract with the taxpayer that is entered into prior to the production of the intangible. For example, a technological process or other know-how that is developed specifically for a taxpayer under an arrangement with another person pursuant to which the taxpayer retains all rights to the process or know-how would be considered created by the taxpayer.

The exception for "self-created" intangibles would not apply to the entering into (or renewal of) a contract for the use of a section 197 intangible. Thus, for example, the exception would not apply to the capitalized costs incurred by a licensee in connection with the entering into (or renewal of) a contract for the use of know-how or

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date of acquisition. The present value of such rent would be presumed to be less than the value of the tangible property if the duration of the lease is less than the economic useful life of the property.

[82] For purposes of this exception, the term "interest under any existing indebtedness" would include mortgage servicing rights to the extent that the rights are stripped coupons under section 1286 of the Code. See Rev. Rul. 91-46, 1991-34 I.R.B. 5 (August 26, 1991).

other section 197 intangible. These capitalized costs would be amortized over the 14-year period specified in the bill.

In addition, the exception for "self-created" intangibles would not apply to: (1) any license, permit, or other right that is granted by a governmental unit or an agency or instrumentality thereof; (2) any covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (3) any franchise, trademark, or trade name. Thus, for example, the capitalized costs incurred in connection with the development or registration of a trademark or trade name would be amortized over the 14-year period specified in the bill.

Special rules

Determination of adjusted basis

The adjusted basis of a section 197 intangible that is acquired from another person generally would be determined under the principles of present law that apply to tangible property that is acquired from another person. Thus, for example, if a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible would be increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount would be amortized ratably over the remaining months in the 14-year amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.

Treatment of certain dispositions of amortizable section 197 intangibles

Special rules would apply if a taxpayer disposes of a section 197 intangible that was acquired in a transaction or series of related transactions and, after the disposition,[83] the taxpayer retains other section 197 intangibles that were acquired in such transaction or series of related transactions.[84] First, no loss would be recognized by reason of such a disposition. Second, the adjusted bases of the retained section 197 intangibles that were acquired in connection with such transaction or series of related transactions would be increased by the amount of any loss that is not recognized. The adjusted basis of any such retained section 197 intangible would be increased by the product of (1) the amount of the loss that is not recognized solely by reason of this provision, and (2) a fraction, the numerator of which is the adjusted basis of the intangible as of the date of the disposition and the denominator of which is the total

[83] For this purpose, the abandonment of a section 197 intangible or any other event that renders a section 197 intangible worthless would be considered a disposition of a section 197 intangible.

[84] These special rules would not apply to a section 197 intangible that is separately acquired (i.e., a section 197 intangible that is acquired other than in a transaction or a series of related transactions that involve the acquisition of other section 197 intangibles). Consequently, a loss may be recognized upon the disposition of a separately acquired section 197 intangible. In no event, however, would the termination or worthlessness of a portion of a section 197 intangible be considered the disposition of a separately acquired section 197 intangible. For example, the termination of one or more customers from an acquired customer list or the worthlessness of some information from an acquired data base would not be considered the disposition of a separately acquired section 197 intangible.

adjusted bases of all such retained section 197 intangibles as of the date of the disposition.

For purposes of these rules, all persons treated as a single taxpayer under section 41(f) of the Code would be treated as a single taxpayer. Thus, for example, a loss would not be recognized by a corporation upon the disposition of a section 197 intangible if after the disposition a member of the same controlled group as the corporation retains other section 197 intangibles that were acquired in the same transaction (or a series of related transactions) as the section 197 intangible that was disposed of. It is anticipated that the Treasury Department will provide rules for taking into account the amount of any loss that is not recognized due to this rule (for example, by allowing the corporation that disposed of the section 197 intangible to amortize the loss over the remaining portion of the 14-year amortization period).

Treatment of certain nonrecognition transactions

If any section 197 intangible is acquired in a transaction to which section 332, 351, 361, 721, 731, 1031, or 1033 of the Code applies (or any transaction between members of the same affiliated group during any taxable year for which a consolidated return is filed),[85] the transferee would be treated as the transferor for purposes of applying this provision with respect to the amount of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor.

For example, assume that an individual owns an amortizable section 197 intangible that has been amortized under section 197 for 4 full years and has a remaining unamortized basis of $300,000. In addition, assume that the individual exchanges the asset and $100,000 for a like-kind amortizable section 197 intangible in a transaction to which section 1031 applies. Under the bill, $300,000 of the basis of the acquired amortizable section 197 intangible would be amortized over the 10 years remaining in the original 14-year amortization period for the transferred asset and the other $100,000 of basis would be amortized over the 14-year period specified in the bill.[86]

Treatment of certain partnership transactions

Generally, consistent with the rules described above for certain nonrecognition transactions, a transaction in which a taxpayer acquires an interest in an intangible held through a partnership (either before or after the transaction) would be treated as an acquisition to which the bill applies only if, and to the extent that, the acquiring taxpayer obtains, as a result of the transaction, an increased basis for such intangible.[87]

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[85] The termination of a partnership under section 708(b)(1)(B) of the Code would be a transaction to which this rule applies. In such a case, the bill would apply only to the extent that the adjusted basis of the section 197 intangibles before the termination exceeds the adjusted basis of the section 197 intangibles after the termination. (See the example below in the discussion of "Treatment of certain partnership transactions.")

[86] No inference is intended whether any asset treated as a section 197 intangible under the bill is eligible for like kind exchange treatment.

[87] This discussion is subject to the application of the anti-churning rules which are discussed below.

For example, assume that A, B and C each contribute $700 for equal shares in partnership P, which on January 1, 1993, acquires as its sole asset an amortizable section 197 intangible for $2,100. Assume that on January 1, 1997, (1) the sole asset of P is the intangible acquired in 1993, (2) the intangible has an unamortized basis of $1,500 and A, B, and C each have a basis of $500 in their partnership interests, and (3) D (who is not related to A, B, or C) acquires A's interest in P for $800. Under the bill, if there is no section 754 election in effect for 1997, there would be no change in the basis or amortization of the intangible and D would merely step into the shoes of A with respect to the intangible. D's share of the basis in the intangible would be $500, which would be amortized over the 10 years remaining in the amortization period for the intangible.

On the other hand, if a section 754 election is in effect for 1997, then D would be treated as having an $800 basis for its share of P's intangible. Under section 197, D's share of income and loss would be determined as if P owns two intangible assets. D would be treated as having a basis of $500 in one asset, which would continue to be amortized over the 10 remaining years of the original 14-year life. With respect to the other asset, D would be treated as having a basis of $300 (the amount of step-up obtained by D under section 743 as a result of the section 754 election) which would be amortized over a 14-year period starting with January of 1997. B and C would each continue to share equally in a $1,000 basis in the intangible and amortize that amount over the remaining 10-year life.

As an additional example, assume the same facts as described above, except that D acquires both A's and B's interests in P for $1,600. Under section 708, the transaction is treated as if P is liquidated immediately after the transfer, with C and D each receiving their pro rata share of P's assets which they then immediately contribute to a new partnership. The distributions in liquidation are governed by section 731. Under the bill, C's interest in the intangible would be treated as having a $500 basis, with a remaining amortization period of 10 years. D would be treated as having an interest in two assets: one with a basis of $1,000 and a remaining amortization period of 10 years, and the other with a basis of $600 and a new amortization period of 14 years.

The bill would also change the treatment of payments made in liquidation of the interest of a deceased or retired partner in exchange for goodwill. Except in the case of payments made on the retirement or death of a general partner of a partnership for which capital is not a material income-producing factor, such payments would not be treated as a distribution of partnership income. Under the bill, however, if the partnership makes an election under section 754, section 734 would generally provide the partnership the benefit of a stepped-up basis for the retiring or deceased partner's share of partnership goodwill and an amortization deduction for the increase in basis under section 197.

For example, using the facts from the preceding examples, assume that on January 1, 1997, A retires from the partnership in exchange for a payment from the partnership of $800, all of which is in exchange for A's interest in the intangible asset owned by P. Under the bill, if there is a section 754 election in effect for 1997, P

would be treated as having two amortizable section 197 intangibles: one with a basis of $1,500 and a remaining life of 10 years, and the other with a basis of $300 and a new life of 14 years.

Treatment of certain reinsurance transactions

The bill would apply to any insurance contract that is acquired from another person through an assumption reinsurance transaction (but not through an indemnity reinsurance transaction).[88] The amount taken into account as the adjusted basis of such a section 197 intangible, however, would equal the excess of (1) the amount paid or incurred by the acquirer/reinsurer under the assumption reinsurance transaction,[89] over (2) the amount of the specified policy acquisition expenses (as determined under section 848 of the Code) that is attributable to premiums received under the assumption reinsurance transaction. The amount of the specified policy acquisition expenses of an insurance company that is attributable to premiums received under an assumption reinsurance transaction would be amortized over the period specified in section 848 of the Code.

Treatment of amortizable section 197 intangible as depreciable property

For purposes of chapter 1 of the Internal Revenue Code, an amortizable section 197 intangible would be treated as property of a character which is subject to the allowance for depreciation provided in section 167. Thus, for example, an amortizable section 197 intangible would not be a capital asset for purposes of section 1221 of the Code, but an amortizable section 197 intangible held for more than one year generally would qualify as property used in a trade or business for purposes of section 1231 of the Code. As further examples, an amortizable section 197 intangible would constitute section 1245 property, and section 1239 of the Code would apply to any gain recognized upon the sale or exchange of an amortizable section 197 intangible, directly or indirectly, between related persons.

Treatment of certain amounts that are properly taken into account in determining the cost of property that is not a section 197 intangible

The bill would not apply to any amount that is properly taken into account under present law in determining the cost of property that is not a section 197 intangible. Thus, for example, no portion of the cost of acquiring real property that is held for the production of rental income (for example, an office building, apartment building or shopping center) would be taken into account under the bill (*i.e.*, no goodwill, going concern value or any other section 197 intangible would arise in connection with the acquisition of such real

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[88] An assumption reinsurance transaction is an arrangement whereby one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company). In addition, for purposes of the bill, an assumption reinsurance transaction would include any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338 of the Code.

[89] The amount paid or incurred by the acquirer/reinsurer under an assumption reinsurance transaction would be determined under the principles of present law. See Treas. Reg. sec. 1.817-4(d)(2).

property). Instead, the entire cost of acquiring such real property would be included in the basis of the real property and would be recovered under the principles of present law applicable to such property.

Modification of purchase price allocation and reporting rules for certain asset acquisitions

Sections 338(b)(5) and 1060 of the Code authorize the Treasury Department to promulgate regulations that provide for the allocation of purchase price among assets in the case of certain asset acquisitions. Under regulations that have been promulgated pursuant to this authority, the purchase price of an acquired trade or business must be allocated among the assets of the trade or business using the "residual method."

Under the residual method specified in the Treasury regulations, all assets of an acquired trade or business are divided into the following four classes: (1) Class I assets, which generally include cash and cash equivalents; (2) Class II assets, which generally include certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency; (3) Class III assets, which generally include all assets other than those included in Class I, II, or IV (generally all furniture, fixtures, land, buildings, equipment, other tangible property, accounts receivable, covenants not to compete, and other amortizable intangible assets); and (4) Class IV assets, which include intangible assets in the nature of goodwill or going concern value. The purchase price of an acquired trade or business (as first reduced by the amount of the assets included in Class I) is allocated to the assets included in Class II and Class III based on the value of the assets included in each class. To the extent that the purchase price (as reduced by the amount of the assets in Class I) exceeds the value of the assets included in Class II and Class III, the excess is allocable to assets included in Class IV.

It is expected that the present Treasury regulations which provide for the allocation of purchase price in the case of certain asset acquisitions will be amended to reflect the fact that the bill allows an amortization deduction with respect to intangible assets in the nature of goodwill and going concern value. It is anticipated that the residual method specified in the regulations will be modified to treat all amortizable section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which the bill applies.

Section 1060 also authorizes the Treasury Department to require the transferor and transferee in certain asset acquisitions to furnish information to the Treasury Department concerning the amount of any purchase price that is allocable to goodwill or going concern value. The bill provides that the information furnished to the Treasury Department with respect to certain asset acquisitions is to specify the amount of purchase price that is allocable to amortizable section 197 intangibles rather than the amount of purchase price that is allocable to goodwill or going concern value. In addition, it is anticipated that the Treasury Department will exercise its existing regulatory authority to require taxpayers to furnish such additional information as may be necessary or appropriate to

carry out the provisions of the bill, including the amount of purchase price that is allocable to intangible assets that are not amortizable section 197 intangibles.

Regulatory authority

The Treasury Department would be authorized to prescribe such regulations as may be appropriate to carry out the purposes of the bill including such regulations as may be appropriate to prevent avoidance of the purposes of the bill through related persons or otherwise. It is anticipated that the Treasury Department will exercise its regulatory authority where appropriate to clarify the types of intangible property that constitute section 197 intangibles.

Effective Date

In general

Section 4501 of H.R. 4210 generally would apply to property acquired after the date of enactment of the bill. As more fully described below, however, a taxpayer would be allowed to elect to apply the bill to either (1) all property acquired after July 25, 1991, or (2) all property acquired in certain taxable years for which the statute of limitations for the assessment of tax has not expired. In addition, a taxpayer would be allowed to elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill pursuant to a binding written contract in effect on February 14, 1992. Finally, special "anti-churning" rules would apply to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill would apply.

Election to apply bill to property acquired after July 25, 1991

A taxpayer would be allowed to elect to apply the bill to all property acquired by the taxpayer after July 25, 1991. If a taxpayer makes this election, the bill would also apply to all property acquired after July 25, 1991, by any taxpayer that is under common control with the electing taxpayer (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code) at any time during the period that begins on November 22, 1991, and that ends on the date that the election is made.[90]

The election would be made at such time and in such manner as may be specified by the Treasury Department,[91] and the election

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[90] An amortization deduction would not be allowed under the bill, however, for goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill if: (1) the section 197 intangible is acquired after July 25, 1991; and (2) either (a) the taxpayer or a related person held or used the intangible on July 25, 1991; (b) the taxpayer acquired the intangible from a person that held such intangible on July 25, 1991, and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible on July 25, 1991. (See below for a more detailed description of these "anti-churning" rules.)

[91] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the date of enactment of the bill.

could be revoked only with the consent of the Treasury Department.

Election to apply bill to property acquired during certain open taxable years

A taxpayer would be allowed to elect to apply the bill to all property acquired by the taxpayer in any taxable year for which the statute of limitations for the assessment of tax has not expired as of July 25, 1991 (other than a taxable year that occurs before a taxable year for which the statute of limitations for the assessment of tax has expired as of July 25, 1991).[92] If a taxpayer makes this election, the bill would also apply to all property acquired during any such open taxable year of any other taxpayer that is under common control with the electing taxpayer (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code) at any time during the period that begins on November 22, 1991, and that ends on the date that the election is made.

In the case of any section 197 intangible that was acquired by an electing taxpayer (or a person under common control with the electing taxpayer) on or before the date of enactment of the bill, the adjusted basis of the intangible would be amortized ratably over a 17-year period that begins with the month that the intangible was acquired.[93] An electing taxpayer (as well a person under common control with an electing taxpayer) would be required to pay interest on any deficiency that arises as a result of the election. The IRS, however, would not be required to pay interest on any refund that is payable as a result of the election. In addition, the statute of limitations on the assessment of tax and a claim for refund of tax for any open taxable year to which the election applies would not expire any sooner than two years after the date of the election.

The bill would also provide a special rule for property that is acquired by certain electing taxpayers in certain taxable years for which the statute of limitations has expired as of July 25, 1991. If (1) an "open taxable year" election applies to a taxpayer, (2) the taxpayer and the IRS have agreed on the treatment of an acquired intangible for a taxable year to which the "open taxable year" election does not apply, and (3) as of February 14, 1992, there was a dispute between the taxpayer and the IRS that arose because the IRS took a position with respect to an open taxable year that was contrary to that specified in the agreement with respect to the treatment of the acquired intangible, then the taxpayer would be

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[92] The statute of limitations for a taxable year would be treated as expired for purposes of this election if, as of July 25, 1991, the statute of limitations for such taxable year is extended solely with respect to issues that do not involve the proper treatment for Federal income tax purposes of acquired intangibles that are defined as section 197 intangibles under the bill.

[93] An amortization deduction would not be allowed under the bill, however, for goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill if: (1) the section 197 intangible is acquired after July 25, 1991; and (2) either (a) the taxpayer or a related person held or used the intangible on July 25, 1991; (b) the taxpayer acquired the intangible from a person that held such intangible on July 25, 1991, and, as part of the transaction, the user of the intangible did not change; or (c) the taxpayer granted the right to use the intangible to a person (or a person related to such person) that held or used the intangible on July 25, 1991. (See below for a more detailed description of these "anti-churning" rules.)

allowed to amortize such intangible in accordance with the agreement between the taxpayer and the IRS.

The "open taxable year" election would be made at such time and in such manner as may be specified by the Treasury Department,[94] and the election could be revoked only with the consent of the Treasury Department.

Elective binding contract exception

A taxpayer would also be allowed to elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill if the property is acquired pursuant to a binding written contract that was in effect on February 14, 1992, and at all times thereafter until the property is acquired. This election could not be made by any taxpayer that is subject to either of the elections described above that would apply the provisions of the bill to property acquired before the date of enactment of the bill.

The election would be made at such time and in such manner as may be specified by the Treasury Department,[95] and the election could be revoked only with the consent of the Treasury Department.

Anti-churning rules

Special rules are provided by the bill to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill would apply.

Under these "anti-churning" rules, goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill could not be amortized as an amortizable section 197 intangible if: (1) the section 197 intangible is acquired by a taxpayer after the date of enactment of the bill; and (2) either (a) the taxpayer or a related person held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill; (b) the taxpayer acquired the intangible from a person that held such intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill. The anti-churning rules, however, would not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a) (relating to property acquired from a decedent).

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[94] It is anticipated that Treasury Department will require the election to be made by the due date of the return for the taxable year that includes the date of enactment of the bill.

[95] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the date of enactment of the bill.

For purposes of the anti-churning rules, a person would be related to another person if: (1) the person bears a relationship to that person which would be specified in section 267(b)(1) or 707(b)(1) of the Code if those sections were amended by substituting 20 percent for 50 percent; or (2) the persons are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code). A person would be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

In addition, in determining whether the anti-churning rules apply with respect to any increase in the basis of partnership property under section 732, 734, or 743 of the Code, the determinations would be made at the partner level and each partner would be treated as having owned or used the partner's proportionate share of the partnership property. Thus, for example, the anti-churning rules would not apply to any increase in the basis of partnership property that occurs upon the acquisition of an interest in a partnership that has made a section 754 election if the person acquiring the partnership interest is not related to the person selling the partnership interest.[96]

The bill also contains a general anti-abuse rule that would apply to any section 197 intangible that is acquired by a taxpayer from another person. Under this rule, a section 197 intangible could not be amortized under the provisions of the bill if the taxpayer acquired the intangible in a transaction one of the principal purposes of which is to (1) avoid the requirement that the intangible be acquired after the date of enactment of the bill or (2) avoid any of the anti-churning rules described above that are applicable to goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill.

Finally, the special rules described above that apply in the case of a transactions described in section 332, 351, 361, 721, 731, 1031, or 1033 of the Code would also apply for purposes of the effective date. Consequently, if the transferor of any section 197 property is not allowed an amortization deduction with respect to such property under this provision, then the transferee would not be allowed an amortization deduction under this provision to the extent of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor. In addition, this provision would apply to any subsequent transfers of any such property in a transaction described in section 332, 351, 361, 721, 731, 1031, or 1033.

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[96] In addition to these rules, it is anticipated that rules similar to the anti-churning rules under section 168 of the Code will apply in determining whether persons are related. See Prop. Treas. Reg. 1.168-4 (February 16, 1984). For example, it is anticipated that a corporation, partnership, or trust that owned or used property at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and that is no longer in existence will be considered to be in existence for purposes of determining whether the taxpayer that acquired the property is related to such corporation, partnership, or trust.

As a further example, it is anticipated that in the case of a transaction to which section 338 of the Code applies, the corporation that is treated as selling its assets will not to be considered related to the corporation that is treated as purchasing the assets if at least 80 percent of the stock of the corporation that is treated as selling its assets is acquired by purchase after July 25, 1991.

B. S. 1245

Explanation of the Bill

S. 1245, as introduced by Senators Daschle and Symms on June 6, 1991, would amend section 167 of the Code to provide that if a taxpayer demonstrates through any reasonable method that (1) customer base, market share, or any other similar intangible item has an ascertainable value that is separate and distinct from other assets (including goodwill and going concern value) acquired as part of the same transaction, and (2) the intangible item has a limited useful life which can be reasonably estimated, then the basis of the intangible shall be amortized over such useful life.

In addition, S. 1245 would grant the Treasury Department the authority to promulgate regulations establishing safe harbor useful lives for specific classes of customer base, market share, or other similar intangible items which are generally consistent with the actual useful lives for the items within such classes. In addition, the Treasury Department would be authorized to promulgate regulations concerning the manner in which such intangible items may be valued separately and distinctly from other assets (including goodwill and going concern value).

Effective Date

S. 1245 would apply to all open taxable years (i.e., all taxable years for which the statute of limitations has not expired).

IV. ISSUES REGARDING THE FEDERAL INCOME TAX TREATMENT OF INTANGIBLE ASSETS

A. Treatment of Intangible Assets in General

Theoretically, any decline in the values of both tangible and intangible assets should be reflected in the measurement of taxable income derived from a trade or business. More accurate measures of the declines (and increases as well) in the values of assets would lead to more accurate measures of taxable income. Generally, the most accurate method of measuring taxable income would involve marking the value of the tangible or intangible assets to market each accounting period. However, such an approach would involve difficulties in identifying accurate values, particularly for assets that are not regularly traded. In addition, a mark-to-market system would involve significant complexity and compliance burdens.

Instead, depreciation or amortization allowances are typically determined based on an approximation of the expected decline in the value of the assets used in a trade or business. Theoretically, the most accurate of these schedules for both tangible and intangible assets would be unique to each business, so that different taxpayers would have different schedules for identical assets.[97] However, the use of a taxpayer-by-taxpayer facts and circumstances determination of depreciation for Federal income tax purposes has resulted in numerous disputes between taxpayers and the Internal Revenue Service.[98]

In accounting for the decline in value of an asset, it is generally necessary to identify three items: valuation (or cost), useful life, and rate of decline in value. Some tangible assets trade in markets on a stand-alone basis, allowing reasonably well-settled, unbiased estimates of the market value for those tangible assets not acquired on a stand-alone basis.[99] In addition, tangible assets are often relatively easy to classify into homogeneous groups, which may be treated in a like manner. If there is an active secondary market for tangible assets, it is possible to observe the decline in the market prices of representative assets. This, in turn, permits objective estimates to be made of the useful life and the schedule of economic decline for these assets. Such schedules can be used as a basis for providing depreciation schedules for similar assets for Federal income tax purposes and to provide certainty to taxpayers

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[97] For example, a truck rented on a weekly basis to multiple users would likely experience a different pattern of decline in economic value than a similar truck used solely by an owner-operator in a wholesale business.

[98] See H. Rept. No. 1337, 83rd Cong., 2nd Sess. 22 (1954) for a discussion of the controversies surrounding the interpretation of "reasonable allowance for depreciation."

[99] Note that it is rather easy to value single assets acquired on a stand-alone basis by simply looking at the price paid by a willing buyer to a willing seller. However, defining exactly what constitutes a single asset (e.g., the bundle of property rights that makes up a single asset) and defining what constitutes a stand-alone acquisition may be difficult in particular situations.

as to the amount of depreciation deductions allowable for any asset for any taxable period.[100]

In contrast, intangible assets have often been considered harder to classify into homogeneous groups because the decline in value of these assets depends to a large extent on the particular trade or business in which the assets are used. Moreover, the valuation of intangible assets is problematic because competitive markets for these assets frequently do not exist. The lack of a market for either new or used intangible assets generally means that it is not possible to observe the decline in market prices as a means to determine the useful life or the schedule of decline in the economic value for these assets.[101] This difference from tangible assets could arguably justify a different treatment for cost recovery purposes.[102]

B. Treatment of Goodwill and Going Concern Value

The two legislative proposals differ in the scope of the assets they address. The principal difference involves the treatment of goodwill and going concern value (hereinafter together referred to as "goodwill"). As discussed in Part II above, goodwill is not amortizable under present law. S. 1245 would retain the present-law treatment of goodwill, but would provide that a customer-based intangible asset is amortizable if the taxpayer demonstrates through any reasonable method that (1) the asset has an ascertainable value that is separate and distinct from other assets (including goodwill) acquired as part of the same transaction and (2) the asset has a limited useful life that can be reasonably estimated. Section 4501 of H.R. 4210, on the other hand, would allow taxpayers to amortize the cost of acquired goodwill in the same manner and over the same period as other acquired intangible assets.

One consideration to be taken into account in determining whether goodwill should be amortized for Federal income tax purposes is whether the amortization of goodwill would provide a more accurate measure of economic income.

It may be argued that goodwill is not a wasting asset and, thus, amortization deductions should not be allowed with respect to goodwill. Alternatively, it may be argued that as long as current deductions are allowed for the costs associated with maintaining the value of goodwill, the amortization of the costs of acquired goodwill is not required in order to provide an accurate measure of economic income. For example, assume that a taxpayer acquires all the assets of a business, one of which is goodwill. Further, assume that the taxpayer engages in advertising and incurs other expenditures in the operation of its business that in part preserve the value of this goodwill.

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[100] See, e.g., Rev. Proc. 87-56, 1987-2 C.B. 674, for the class lives and recovery periods for various tangible assets and Rev. Proc. 87-57, 1987-2 C.B. 687, for the depreciation allowances provided for tangible assets of various recovery periods.

[101] Further discussion of problems encountered in the valuation of intangible assets may be found in "A Study of Intercompany Pricing," the 1988 Treasury White Paper.

[102] Under present law, the costs of tangible and intangible assets are recovered differently. The costs of tangible assets generally are recovered pursuant to the lives, methods, and conventions prescribed by section 168. However, the costs of amortizable intangible assets generally are recovered pursuant to methods and periods established as appropriate on the basis of the facts and circumstances of the taxpayers holding such assets.

Under present law, the amortization of the acquired goodwill is not allowed while the advertising and other business expenses are currently deductible. It may be argued that income is properly measured under present law because although goodwill may be a wasting asset, the currently deducted costs restore the value of the goodwill. The basis for this argument is that theoretically expenses attributable to replacing goodwill should be capitalized and amortized over the life of the goodwill and that as long as this is not required, denying amortization for goodwill is appropriate even if goodwill is a wasting asset.

On the other hand, it may be argued that goodwill is, in fact, a wasting asset and, thus, should be treated as such for Federal income tax purposes. For example, goodwill has been defined as "the expectancy of continued patronage," [103] or "the expectancy that the old customers will resort to the old place." [104] Clearly a business that has loyal customers is more valuable than a business that does not. However, this customer loyalty cannot reasonably be expected to last forever as customers relocate or die, or have needs or tastes that change over time.[105] Customer loyalty would also be expected to decline faster if a business does not take steps to continue to satisfy existing or changing customer needs (*e.g.*, by maintaining or expanding its level of service). It may be argued that goodwill is not amortizable under present law principally because taxpayers cannot overcome their burden of showing over what period goodwill wastes. Thus, specifying a recovery period for the cost of goodwill is arguably appropriate in that it would provide a measure of "rough justice."

It may further be argued that permitting the deduction of costs that may contribute to the replacement of diminishing goodwill does not justify denying a deduction for goodwill. Both creators and purchasers of businesses with goodwill deduct ordinary and necessary business expenses currently and there would be significant administrative and other issues involved in attempting to identify costs to be capitalized as contributing to the creation or replacement of goodwill. Permitting a deduction for goodwill arguably would more nearly equalize the treatment of the creator and the purchaser of goodwill than does present law.

In addition, it may be argued that the amortization of goodwill is necessary to obtain the greatest degree of simplification in the tax treatment of intangible assets. Under present law, upon the acquisition of the assets of a trade or business, a taxpayer has a tax incentive to allocate as little of the purchase price of the business as possible to goodwill. This incentive has resulted in taxpayers undertaking costly and time-consuming appraisals in order to identify, allocate purchase price to, amortize, and defend the amortization of, intangible assets other than goodwill even if these other assets have characteristics similar to goodwill.[106] Similar burdens

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[103] *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962).

[104] *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1962).

[105] Those who believe that goodwill is a wasting asset point out that U.S. financial accounting rules require goodwill to be amortized. See Accounting Principles Board Opinion No. 17, requiring amortization over no more than 40 years.

[106] See, for example, the discussion in *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3rd Cir. 1991), *cert. granted* April 6, 1992, which compares goodwill to customer lists.

are imposed on the Internal Revenue Service in connection with the examination of income tax returns that claim amortization deductions for the costs of acquired intangible assets.

By not changing the present-law treatment of goodwill, S. 1245 would retain the incentive to allocate as little of the purchase price of an acquired trade or business as possible to goodwill. By allowing amortization for goodwill and other assets over the same period, section 4501 of H.R. 4210 would significantly lessen the incentive of taxpayers to identify assets distinct from goodwill in an attempt to obtain more favorable amortization. In some cases there may still be some incentive for taxpayers to allocate value to those identifiable assets that might be disposed of separately after an acquisition, in order to minimize any gain on such a disposition. However, the identification of amortization periods for any such assets would no longer be an issue.[107]

C. Determination of the Amortization Period and Method for Intangible Assets

Both legislative proposals address the issue of whether the cost of intangible assets may be amortized, and, if so, over what period and under what method. S. 1245 provides that customer-based or other similar intangible assets would be amortized over the useful life of the asset if a value separate from goodwill can be established. In addition, under S. 1245, the Treasury Department would be granted regulatory authority to promulgate safe-harbor recovery periods consistent with industry practice and experience for the types of intangible assets to which the bill applies. Section 4501 of H.R. 4210 provides that all intangible assets to which the bill applies would be amortized over a 14-year period using a straight-line method.

Assuming that amortization deductions are allowed for the cost of some or all intangible assets, issues arise with respect to the length of the period over which these deductions should be allowed and the method to be used (*i.e.*, should amortization be on a straight-line method over the period or should it follow a more accelerated pattern). Specifically, issues arise as to whether the recovery period and method for an intangible asset should be (1) based on the taxpayer's particular facts and circumstances, (2) determined pursuant to specific lives and methods provided by statute or regulations for various classes of similar types of intangible assets, or (3) a single life and method applicable to all or most intangible assets.

Facts and circumstances determination

The principal argument in favor of a facts and circumstances determination is that this method may provide the most accurate means of measuring income. It may be argued that the use of a single recovery period and method for all intangibles is arbitrary and, depending upon the length of the period and the method selected, results in some assets being amortized too quickly while

[107] Neither of the proposals would address issues regarding allocations between intangible assets and tangible assets.

others are amortized too slowly. It may also be argued that recovery periods developed pursuant to Treasury studies would likewise be somewhat arbitrary in that they would tend to average the experience of many taxpayers, where such averaging may not be reflect the situation of a particular taxpayer. For example, a customer list in an industry that undergoes frequent product innovations may have a life that is significantly different than a customer list that involves a standard product or service.

Specific separate recovery periods and methods for different assets

The adoption of specific recovery periods and methods for different types of intangible assets would follow the approach of the present-law system for tangible property. It may be argued that such a system, while admittedly not exact, could be designed to provide a reasonably appropriate matching of the cost of an asset to the periods over which it is used.[108] On the other hand, the identification of appropriate classes of intangible assets and appropriate amortization schedules could be extremely difficult, given the diversity of intangible assets that taxpayers have identified, the variety of valuation methods that have been used, and the frequent lack of comparables in the case of many intangible assets. In addition, it may be argued that to the extent any specific schedules permitted more rapid amortization for one class of assets than another, there would still be an incentive for taxpayers to allocate value to the asset with the more rapid amortization. Such allocations could be particularly difficult to police or challenge in the absence of readily identifiable market values for these assets.

Single recovery period and method

The use of a single recovery period and method for all or most intangible assets may be criticized as arbitrary. Assets that have been amortized over a longer period than the specified method under present law arguably would receive unduly favorable treatment, while assets that have been amortized over a shorter period under present law arguably would receive unduly harsh treatment.

On the other hand, it may be argued that the present-law use of taxpayer-specific facts and circumstances has resulted in conflicting results in apparently similar cases, a situation which also could be criticized as arbitrary. Furthermore, from a simplification standpoint, it may be argued that only a single recovery period can significantly reduce the number of amortization disputes between the IRS and taxpayers.[109]

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[108] See e.g., the GAO Report, n. 26, suggesting that it would be possible to design a system with different recovery periods for different types of intangible assets.

[109] Under section 4501 of H.R. 4210, taxpayers would be required to continue to identify and value certain acquired intangible assets for purposes of determining the tax consequences on subsequent disposition of the asset. Although no loss is recognized on disposition of one asset out of a group of assets, it is necessary to determine whether gain is recognized. However, separate valuation would not generally be necessary for assets that would not likely be the subject of a separate disposition, such as goodwill or many of the other separate assets that taxpayers identify under present law.

D. Retroactive Application of the Proposals

H.R. 4210

Section 4501 of H.R. 4210 generally would apply to intangible assets that are acquired after the date of enactment of the bill. A taxpayer, however, would be allowed to elect to apply the provision (using a 17-year amortization period rather than a 14-year amortization period) retroactively to all property acquired by the taxpayer in certain taxable years for which the statute of limitations for the assessment of tax has not expired as of July 25, 1991. If a taxpayer makes this election, the bill also would apply to all property acquired during any such "open taxable year" of certain taxpayers that are related to the electing taxpayer at any time between November 22, 1991, and the date of the election.

The principal argument advanced in support of the retroactive election provided by H.R. 4210 is that the election would eliminate many existing or future controversies between taxpayers and the IRS concerning the proper Federal income tax treatment of the cost of acquiring intangible assets. It is argued that the retroactive election would "free-up" the resources of taxpayers, the IRS, and the courts, which could then be applied to more productive activities. In addition, it is argued by some that the retroactive election would provide consistent results for all taxpayers that make the election and, as such, would be fairer than present law.

On the other hand, it is argued by others that the retroactive election is unnecessary because taxpayers and the IRS are likely to settle existing controversies expeditiously due to the fact that, upon enactment of the bill, no settlement will serve as a precedent for the treatment of intangibles acquired in the future. Others argue that if the purpose of the retroactive election is to settle controversies, then the retroactive feature of the bill should be mandatory and not elective.

In addition, others observe that if the rationale for the retroactive election is to eliminate controversies between taxpayers and the IRS, then the retroactive election provided by H.R. 4210 is too broad because it would allow an amortization deduction with respect to goodwill and other similar intangible assets for which a taxpayer did not claim an amortization deduction for Federal income tax purposes. These individuals argue that if retroactive relief is provided, the relief should be limited to acquired intangible assets that the taxpayer claimed as amortizable on the original Federal income tax return for the taxable year that includes the date of the acquisition of the intangible assets.

In many cases, a taxpayer making the retroactive election will be entitled to a refund of taxes previously paid, especially where a significant portion of the purchase price of an acquired trade or business was allocated to goodwill and other intangible assets that are not amortizable for Federal income tax purposes. It is argued that if the purpose of the retroactive election is to settle controversies between taxpayers and the IRS, an electing taxpayer should not receive more favorable treatment than the treatment originally claimed on the Federal income tax return of the taxpayer. This objective can be achieved if the retroactive election is limited to acquired intangible assets that a taxpayer claimed as amortizable on

the original Federal income tax return. Furthermore, if the purpose of the retroactive election is to eliminate controversies between taxpayers and the IRS, such a limitation is justified on the grounds that there is no controversy with respect to the portion of the purchase price of an acquired trade or business that a taxpayer has treated as not amortizable for Federal income tax purposes. On the other hand, such a limitation would favor taxpayers that were aggressive in identifying intangibles that were claimed to be amortizable for Federal income tax purposes and in allocating purchase price to such intangibles.

With respect to the issue of fairness, it is believed by some that the retroactive election could provide an unjustified windfall to taxpayers that make the election. It is argued that many of the taxpayers eligible to make the election acquired a trade or business based on the assumption that the portion of the purchase price of the acquired trade or business that is allocable to goodwill and other intangible assets in the nature of goodwill would not be amortizable for Federal income tax purposes. To the extent that the purchase price of the assets was negotiated based on this assumption, the retroactive election will result in an unjustified windfall to these taxpayers.

Furthermore, with respect to the issue of fairness, the retroactive election has been criticized because it only applies to intangible assets acquired during a taxable year for which the statute of limitations on the assessment of tax has not expired.[110] While limiting the election to intangible assets acquired during taxable years for which the statute of limitations has not expired is likely to exclude taxpayers that do not have an existing (or potential future) controversy with the IRS concerning the proper Federal income tax treatment of acquired intangible assets, it may be viewed as unfair by those taxpayers that settled an IRS audit by agreeing not to amortize certain intangible assets or by agreeing to an amortization period that was, on average, greater than 17 years. In addition, the retroactive election provided by H.R. 4210 is likely to be perceived as unfair by those taxpayers with taxable years for which the statute of limitations on assessment has expired because the taxpayers paid an asserted deficiency relating to the amortization of intangible assets and filed a claim for refund.

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[110] Under a special rule, an electing taxpayer that has entered into an agreement for a taxable year with the IRS, concerning the Federal income tax treatment of an intangible asset that was acquired during a taxable year for which the statute of limitations on the assessment of tax has expired, would be allowed under certain circumstances to amortize such intangible asset in accordance with the agreement in subsequent taxable years if the IRS was challenging that position for those later years. While this provision may provide some certainty for intangible asset acquisitions occurring during a closed taxable year where there is a dispute in a later taxable year, the provision has been criticized for its uneven application. The provision only applies if there is an "agreement" between the IRS and the taxpayer, yet IRS administrative practice in entering into agreements or even raising issues on audit may vary from case to case, especially if the treatment of acquired intangible assets has little or no tax effect for the closed taxable year of the agreement and both the taxpayer and the IRS assumed that the treatment of intangible assets could be raised in a subsequent taxable year for which such treatment could have a significant tax effect. In addition, this special provision only applies to taxpayers that make the general retroactive election provided by H.R. 4210. Such taxpayers must also have a separate acquisition for which the year of acquistion is still open for assesment. Furthermore, this provision also involves selectivity. Although it is directed at disputes where there was a prior year "agreement" with respect to the treatment of intangible assets acquired during a closed taxable year, it does not require the taxpayer to follow this agreement unless an election is made to do so.

Furthermore, the retroactive election provided by H.R. 4210 has been criticized because the election is likely to result in a significant loss of revenue to the Federal Government due to adverse selection. It is believed that many taxpayers making the election would be taxpayers that allocated a significant portion of the purchase price of an acquired trade or business to intangibles that would likely not be amortizable under present law or that would likely be amortizable over a period that is longer than 17 years. In addition, many of these taxpayers will become entitled to a refund of taxes previously paid. On the other hand, it is believed that many taxpayers that allocated a significant portion of the purchase price of an acquired trade or business to intangibles that are arguably amortizable under present law over a period that is shorter than 17 years would not make the election to apply the bill on a retroactive basis, even though others might do so to achieve certainty or curtail the dispute process.

Finally, it is argued that to the extent that a windfall is provided to electing taxpayers, the retroactive election provided by H.R. 4210 may reinforce the view of some that the Federal tax system favors large corporations and wealthy individuals.

S. 1245

S. 1245 would apply to taxable years beginning before, on, or after June 6, 1991 (*i.e.*, to all open taxable years). It is unclear whether S. 1245 would effectively resolve pending disputes. It still would be necessary under S. 1245 to determine whether there is an identifiable asset with a determinable life and a value separate from goodwill.

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