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Income Tax -- Status of Intangible Assets as Depreciable Property

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TAX NOTE

INCOME TAX—STATUS OF INTANGIBLE ASSETS AS DEPRECIABLE PROPERTY

A taxpayer acquired the CBS network affiliation contracts of two television stations in connection with its acquisition of all the assets of these stations. The network affiliation contracts were for two-year terms, automatically and indefinitely renewable for successive two-year terms unless either of the parties gave six months' written notice of its intention to terminate.[1] The taxpayer treated these contracts as depreciable assets and claimed depreciation deductions on the cost allocated to the contracts. The deductions were disallowed by the Commissioner of Internal Revenue. The Tax Court,[2] after considering expert testimony (which was, in turn, supported by statistical data on the annual rate of contract terminations in the industry) ruled (1) that an estimated useful life of the affiliation contracts could be determined with reasonable accuracy, and (2) that the use of the straight-line method over twenty years was a reasonable basis for calculating depreciation of the contracts. On appeal, *held*, reversed: Each contract is more unique than generic, which makes it questionable whether any meaningful general experience could be used to predict its expected valuable life. There being no reasonable basis for the prediction of the expected valuable life of this intangible asset, the asset is not the proper subject of depreciation allowance. *Commissioner v. Indiana Broadcasting Corp.*, 16 Am. Fed. Tax R.2d 5465 (7th Cir. 1965).

To be depreciable, an asset must have a determinable useful life. No problem exists as to the existence of any life span with tangible assets, since these assets are definitely subject to exhaustion.[3] Some intangibles have been found to be definitely subject to exhaustion, the courts having been liberal in calculating their useful life based upon reasonable esti-

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1. The affiliation contracts in question are similar to others in the industry, especially as to the renewal provisions, and are assignable. In Rev. Rul. 57-377, 1957-2 CUM. BULL. 146, the Commissioner found sufficient similarity in television affiliation agreements to permit promulgation of a ruling which was by its terms applicable to all such contracts throughout the industry.

The ruling equated the contracts with goodwill in holding that they were non-depreciable assets. It states in part:

> The cancellation or termination of a satisfactory network station arrangement is not lightly considered. Such cancellation or termination, if it takes place at all, is based on the existence of economic circumstances at the time cancellation or termination is considered and has no relationship to the two-year period of the network contract.

2. Indiana Broadcasting Corp., 41 T.C. 793 (1964).

3. INT. REV. CODE OF 1954, § 167(a) provides:

There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence):

(1) of property used in the trade or business, or

(2) of property held for the production of income.

mates.[4] However, many intangibles are not subject to definite exhaustion. Typical of this class of intangibles are contracts, licenses, and franchises, when they have automatic renewal features. The most difficult problem presented to the courts by this second class of intangibles is the effect of renewal terms on the determination of a limited useful life.

Of the few courts which have considered the question, most have taken the position that such an asset is depreciable over a substantial initial term without regard to possible renewals.[5] Generally, however, when the initial term has not exceeded three years, the majority of courts have refused to disregard the possibility of renewals. Unable to ascertain any definite limit to the possible renewals, these courts have invariably ruled that the life is indefinite, rather than limited, with the result that no depreciation is allowable.[6]

An early case, *Coca-Cola Bottling Co.*,[7] which involved a contract with no fixed or stated term, has most often been cited for the proposition that depreciation is not allowable when the life is indefinite. The definite-

4. Treas. Reg. § 1.167(a)-3 (1956) provides:

> 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.

This regulation and those similar under prior Revenue Acts have been applied by the courts to allow depreciation based upon reasonable estimates. *E.g.*, Latendresse, 26 T.C. 318 (1956), *aff'd*, 243 F.2d 577 (7th Cir. 1957) (the useful life of the right to insurance renewal commissions was actuarially ascertainable); Northern Natural Gas Co. v. O'Malley, 277 F.2d 128 (8th Cir. 1960) (the useful life of right-of-way easements which depended upon availability of natural gas was measurable by the estimated life of the gas reserves). The Service announced in Rev. Rul. 60-317, 1960-2 CUM. BULL. 452 that it will not follow this decision.

5. *E.g.*, Birmingham News Co. v. Patterson, 224 F. Supp. 670 (N.D. Ala. 1963) (a contract with a thirty-year initial period which would be automatically renewable for the succeeding ten-year periods); Flynn, Harrison & Conroy, Inc., 21 B.T.A. 285 (1930) (a contract with a two-year initial term to continue in force from year to year subject to cancellation by either party). The Tax Court later rejected this decision in Westinghouse Broadcasting Co. Inc., 36 T.C. 912, 920 (1961); see also, WDEF Broadcasting Co. v. United States, 215 F. Supp. 818 (E.D. Tenn. 1963) (a television broadcasting license granted by the F.C.C. for an initial three-year term subject to renewal as approved by the F.C.C.). The Service has ruled that an F.C.C. license has an indeterminate useful life and is therefore nondepreciable. Rev. Rul. 56-520, 1956-2 CUM. BULL. 170.

6. Westinghouse Broadcasting Co., Inc. v. Commissioner, 309 F.2d 279 (3d Cir. 1962), *cert. denied* 372 U.S. 935 (1963); KWTX Broadcasting Co. v. Commissioner, 272 F.2d 406 (5th Cir. 1959); Nachman v. Commissioner, 191 F.2d 934 (5th Cir. 1951); Tube Bar, Inc., 15 T.C. 922 (1950).

7. 6 B.T.A. 1333 (1927). The Board of Tax Appeals stated:

> The instrument stipulated that upon the happening of certain contingencies the contract could be canceled by either party and under certain circumstances the privilege granted therein could be revoked by the Coca-Cola Co. and given to another, but the happening of these events was so *indefinite* and *uncertain* as to form no basis for the determination of the useful life of the contract . . .
>
> Under the terms of the contract herein involved there was no exhaustion of the capital investment by the lapse of time. (Emphasis added.) at 1335.

ness proposition was later applied to the license renewal area in a liquor license case, *Nachman v. Commissioner*.[8] The application of the proposition to that case resulted in a denial of depreciation on the grounds that the contemplated repeated renewals of the license obviated any possible calculation of an annual allowance.

The same rationale soon spread to other areas including television licenses granted by the F.C.C. for three-year terms which are renewable upon approval.

In *KWTX Broadcasting Co.*,[9] the court noted that the F.C.C. had never denied a renewal of its three-year license. Since it was therefore "not known from *experience* or *other factors*"[10] that this intangible asset was useful for only a limited period, it was ruled non-depreciable.[11]

In this setting, a controversy arose for the first time as to whether a television affiliation contract had a limited useful life.[12] In this case, the taxpayer, Westinghouse Broadcasting Co., offered evidence through expert testimony that at the time of their franchise acquisition only two further renewals of twenty-four months each might be reasonably certain. Further, the expert testimony indicated that in valuing a network affiliation contract for purposes of resale of a station, the practice was to assume two renewals.

On appeal, the third circuit[13] agreed with the Tax Court that the practice of the experts in assuming two renewals was not sufficient evidence of the contract's probable useful life.[14] Thus, the basis for the

8. See note 6 *supra*.

9. 31 T.C. 952 (1959), *aff'd per curiam* 272 F.2d 406 (5th Cir. 1959); *contra*, WDEF Broadcasting Co. v. United States, 215 F. Supp. 818 (E.D. Tenn. 1963). The allowance of amortization of the initial three-year period of the license was based on what could be called a public policy rationale. The Tennessee District Court reasoned:

> It ill behooves the Government to serve its regulatory ends by granting licenses of a definite, limited duration, reserving the power to grant or refuse renewal, and at the same time to contend for tax purposes that the specified definite duration of such licenses should be disregarded.

As could be expected, the Service announced that this decision would not be followed as a precedent in disposition of similar cases, Rev. Rul. 64-124, 1964-1 CUM. BULL. 105.

10. The taxable year before the Court was governed by the Internal Revenue Code of 1939. The applicable regulation, Treas. Reg. 118, § 39.23(1)-3 (1939), was similar to Treas. Reg. 1.167(a)-3 (1956) cited at note 4 *supra*.

11. In both *Nachman* and *KWTX Broadcasting Co.*, the fifth circuit had little difficulty in establishing that the initial terms of the licenses could reasonably be expected to be renewed. Since the taxpayers in both cases had sought deductions over the initial term only, the question of how many future renewals could be expected to occur was not in issue.

12. Westinghouse Broadcasting Co., 36 T.C. 912 (1961). The automatic renewal provisions of the affiliation contract were identical to those of the instant case. Indiana Broadcasting Corp., 41 T.C. 793 (1964) *rev'd*, 16 Am. Fed. Tax R.2d 5465 (1965).

13. Westinghouse Broadcasting Co. v. Commissioner, 309 F.2d 279 (3d Cir. 1962), *cert. denied*. 372 U.S. 935 (1963).

14. Similarly rejected, as having no probative value with respect to the probable useful life of the contract, was the stipulated fact that 87 NBC affiliation agreements had expired between Jan. 1, 1953 and April 1, 1960. These statistics did not include evidence as to the actual life span of those agreements or as to the number of their renewals.

disallowance of depreciation in *Westinghouse* was insufficiency of evidence.[15]

Despite the holding, however, this novel introduction of industry statistics in the area of intangibles, and the lack of hesitancy by the third circuit to consider termination statistics set the stage for future litigation in this area. It now appeared only necessary that the industry supply sufficient statistical data to overcome the deficiency which was held to exist in *Westinghouse*.[16]

Two years later, in 1964, Indiana Broadcasting met the challenge in the Tax Court.[17] However, a conservative depreciable life of fourteen years was claimed in the trial of the *Indiana Broadcasting* case, rather than the short fifty-five month life claimed in *Westinghouse*. The trial before the Tax Court[18] was devoted primarily to supplying the essential evidence upon which to determine the probable number of future renewals. The taxpayer's own experience did not provide an adequate basis for making this determination. The essential statistics relating to terminations of the industry's affiliation contracts were elaborately presented by the taxpayer's expert witness.[19] While the government disagreed with the accuracy of the conclusions drawn by the taxpayer's expert witness from the industry's experience, surprisingly enough, it did not contend that such experience was irrelevant to the issue.[20]

The court necessarily approached the problem against the backdrop of its prior opinion in *Westinghouse*[21] which had taken judicial notice of industry statistics. The court concluded that the taxpayer's case was not so different from that of the general experience of the industry that the

15. The burden of establishing the reasonableness of the deduction for depreciation is imposed upon the taxpayer by Treas. Reg. 1.167(b)-0(a) (1956). It is also a well-established principle that the Commissioner's determination of a deficiency in tax bears a presumption of correctness. Hoffman v. Commissioner, 298 F.2d 784, 788 (3d Cir. 1962).

16. *Supra* note 12.

17. Indiana Broadcasting Corp., 41 T.C. 793 (1964).

18. *Ibid.*

19. The theory of the statistical tables compiled, was that an annual rate of contract termination for each pertinent period could be obtained by dividing the total number of years commenced by all of the affiliation contracts during a given period into the total number of contract terminations occurring during the same period. Using that termination rate, the taxpayer's witnesses testified that the average life expectancy of any given contract could be determined by applying the Poisson-Exponential Theory of Failure. The crux of that theory is that the percentage of failure of items to which it is applied is a constant. For example, assuming a termination rate from the table of 5 percent per year, 95 percent would fail to survive the second year and so on. The statistics were discussed in Indiana Broadcasting Corp., 16 Am. Fed. Tax R.2d 5465, 5467 (7th Cir. 1965).

20. The Government asserted that a more restricted subgrouping of industry experience was required to prepare an applicable life-expectancy table. The Tax Court refuted this by stating that:

> . . . any selection of prior experience on which to base an estimate of future life can be subjected to some criticism.

Indiana Broadcasting Corp., *supra* note 17, at 813.

21. *Supra* note 13.

useful life of its contracts could not be determined with the degree of accuracy required to permit a "reasonable allowance" for depreciation at the rate of five percent per year.[22]

It should be recognized that a two-fold legal maneuver had been accomplished by the use of industry termination statistics. First, the very relevancy of such statistics in considering whether a particular contract's life is definite was accepted. Second, the burden of proof was carried, in the Tax Court's opinion, to establish the sufficiency of the statistics from an evidentiary standpoint.

The seventh circuit,[23] in reversing the Tax Court, used a shotgun approach in concluding that the life of these contracts was indefinite. It first rejected the statistical validity of the contract life expectancy tables upon which the Tax Court had based its determination of the twenty-year life. Because the industry is "young" and still in a state of flux, the industry experience was deemed to be so colored as to render any decision as to termination rates of affiliation contracts "pure guesswork."[24] The contracts were considered to be assets of a constant or even expanding value, rather than wasting[25] assets. This was based upon the court's analysis of the record which reflected a very high degree of stability in the history of those affiliation contracts which have continued in force for more than eight or nine years.[26]

Lastly, each contract was deemed to be more unique than generic, which made it questionable whether any meaningful general experience could *ever* be shown to be relevant in arriving at its expected useful life.[27]

It is the opinion of the writer that the proper result was reached by the seventh circuit. The Tax Court had overlooked the fact that the contract was not, at its inception, necessarily subject to any exhaustion with the passage of time. The Tax Court's determination of a probable useful life based upon industry experience confused the *computational* aspects of an annual allowance with the question of basic *eligibility* for depreciation. However, the seventh circuit's decision would be more

22. The Tax Court rationalized that the use of general industry experience was a logical rule because the National Treasury could not suffer from the use of a general average by a group of taxpayers. *Id.* at 815.

23. Indiana Broadcasting Corp., 16 Am. Fed. Tax R.2d 5465 (7th Cir. 1965) *reversing*, 41 T.C. 793 (1964).

24. *Id.* at 5469. The Court cited with approval the rationale of Nachman v. Commissioner, *supra* note 11, and KWTX Broadcasting Co. v. Commissioner, *supra* note 9.

25. Wasting property is defined as:

> leasehold interests; royalties; patent rights; interests in things the substance of which is consumed, such as mines, oil and gas wells, quarries and timber lands; interests in things which are consumed in the using or are worn out by use, such as machinery and farm implements.

BLACK, LAW DICTIONARY (4th ed. 1951).

26. *Supra* note 23, at 5469.

27. *Supra* note 23, at 5467.

meaningful if it could be read as classifying these contracts as unique to each taxpayer with the termination statistics of the industry being consequently irrelevant.[28]

Further, if statistics alone were sufficient to estimate useful lives of these assets, the next logical step in judicial thinking would be to allow amortization of the cost of goodwill,[29] supported by statistical analyses of failures in the taxpayer's particular line of business.[30]

If liberality is to be awarded taxpayers in this area, it is submitted that it should be done legislatively and not judicially.

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28. The terminations are not related to the original two-year terms of the contracts, nor do they relate to any future renewal periods. The cause for terminations will usually arise at some later date and will most likely be due to the failure of the operator of the television station to adequately carry on its business in a manner acceptable to the network.

29. Depreciation with respect to goodwill is specifically prohibited by Treas. Reg. 1.167(a)-3 (1956). While the value of a television affiliation contract and goodwill are not synonymous, the same general principles apply to make them both non-depreciable assets. In discussing goodwill the fourth circuit has noted:

> This form of deduction has been denied because of the manifest difficulties inherent in the computation of both the life span and the value of this intangible asset. In fact, goodwill, in any practical sense, has no terminable life; but, rather, it continues in existence just so long as the business continues, and its value fluctuates in direct relationship with the annual variations in the profits of the business with which it is associated.

Dodge Brothers, Inc. v. United States, 118 F.2d 95, 100 (4th Cir. 1941).

30. For more than a century, Dun & Bradstreet has compiled, analyzed, and published national business failure statistics, such as THE FAILURE RECORD THROUGH 1964, which is a failure study by location, industry, age, size, and cause.