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NEW TAX AMORTIZATION RULES
GOOD NEWS FOR GOODWILL - SOME BAD NEWS
by

Martin H. Zern *

BACKGROUND

Prior to 1934, taxpayers had considerable freedom in selecting a useful life for the purposes of depreciating assets. Then, to help finance public works during The Depression, the Treasury Department began to require taxpayers to prove that the useful life selected was appropriate based upon their particular facts and circumstances. This often proved an untenable and, in any event, a costly proposition for many. In 1942, the Treasury Department prescribed detailed useful lives for specific assets.[1] These lives in many cases were more conservative than the lives taxpayers were using. The 1954 Internal Revenue Code liberalized matters significantly by permitting accelerated methods of depreciation, such as, sum-of-the-years-digit and 200% declining balance, although the useful lives previously prescribed were retained. In 1962, the Treasury Department promulgated new useful-life guidelines. Essentially, the new guideline system created extensive industry classifications and specific asset descriptions within each such classification.[2] Moreover, a complicated reserve ratio test was introduced to ensure that actual retirement and replacement of assets was consistent with the useful life selected. Ultimately, the reserve ratio test proved administratively difficult and impracticable.

Due to the problems with the existing system, it was abandoned by the Treasury Department in 1971 and a new system, effective for assets acquired after 1970, was introduced - the Class Life Asset Depreciation Range System (ADR) which eliminated the reserve ratio test.[3] However, the new system also was set up by industry classifications with specific assets listed within each classification. For each asset, the Treasury Department prescribed a range of useful lives ranging from 20% below to 20% above the basic guideline lives under the prior system. Understandably, most taxpayers, desiring as quick a write off as possible, selected 20% below.

Modern Times. Our present depreciation system originated as part of President Ronald Reagan's tax package enacted shortly after he took office which was advertised as an economic stimulus to push the economy out of recession.[4] This system, known as the Accelerated Cost Recovery System (ACRS), significantly simplified tax depreciation by abandoning the lengthy lists of assets under the ADR system. ACRS established just a few classifications (for most taxpayers, only two to three classifications were relevant) and adopted considerably shortened useful lives which did not necessarily have any relationship to the actual useful life of an asset, a major departure from the prior systems. Moreover, a highly accelerated method of depreciation (200% declining balance) for most tangible personal property was permitted. A major change was to allow a very fast write off for real estate (15 years as compared to the 40 years that generally prevailed). An accelerated method of depreciation (175% declining balance) was also permitted for real estate. As is common knowledge, the economy did accelerate during the 80's, with real estate in particular booming. Modifications to the depreciation rules were made over the years increasing the real estate write-off period to 18 years,[5] and later to 19 years.[6]

The major tax changes enacted in 1986 in honor of which the tax law was re-christened the Internal Revenue Code of 1986 (previously, 1954), modified the ACRS system creating new classifications and conventions and, accordingly, it became known as the Modified Accelerated Cost Recovery System (MACRS).[7] Insofar as depreciation is concerned, the major change affected real estate with the adoption of longer useful lives (27.5 years for residential property and 31.5 years for commercial), elimination of the 175% declining balance and, in lieu thereof, adoption of the straight-line method of depreciation. Arguably, the adoption of these longer useful lives with straight-line depreciation, together with enactment of the passive loss rules, were a significant, if not the predominant factor, for the devaluation of real estate in the late 80's, the failure of many savings and loan institutions and the resulting bail out by the Federal Government. President Clinton's recent tax package, the Revenue Reconciliation Bill of 1993 (RRB '93), increased the write-off period for commercial real estate to 39 years.[8]

Intangibles. The depreciation rules discussed above applied and currently apply only to tangible property. For intangible assets, no prescribed write-off periods were in general enacted.[9] However, a Treasury regulation of long standing permitted amortization for an intangible asset used in a trade or business or in the production of income (e.g., and investment activity) provided experience showed the intangible to be of use for only a limited period, "the length of which can be estimated with reasonable accuracy." [10] The regulation specifically states that "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 has been the linchpin behind the IRS denying a deduction for amortization of goodwill, going concern value and assorted other affiliated categories that inventive taxpayers have created in an attempt to differentiate from goodwill what they acquired when purchasing the assets of an operating business. Despite a consistent policy by the IRS in trying to maintain the integrity of the regulation's opposition to the amortization of intangibles, taxpayers over the years have attained some success. The key to circumventing the regulation was within it - namely, showing the intangible, however designated, had a useful life which could be estimated with reasonable accuracy. However, the explication had to be made not to the IRS but to a court because, rest assured, the IRS would litigate the issue. Although the courts were on occasion obliging to taxpayers in this area, the path to success was difficult. A highly litigated item in this

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area was the cost an acquiring taxpayer of business assets might allocate to customer or subscriber lists.

Historically, when a going business was acquired, the courts denied an amortization deduction for the acquisition cost allocated to customer lists because their useful life could not be estimated with reasonable accuracy. Commonly, this was called the "mass asset" rule (i.e., the customer lists were a mass self-regenerating asset). Thus, customer and subscriber lists, location contracts, insurance expirations and similar items were held to be indistinguishable from non amortizable goodwill.[11] However, when a customer list was acquired separately, it was possible to amortize if a determinable life and value were established.[12] But overall, amortization of subscription lists was denied. In 1973, a seminal case in this area, *Houston Chronicle Publishing Co. v. U.S.*,[13] established that subscription lists could be amortized if the taxpayer could prove (1) an ascertainable value separate and distinct from goodwill, and (2) a limited useful life ascertainable with reasonable accuracy. Ultimately, the IRS acquiesced to this decision.[14]

Numerous cases arose after *Houston* with various fact patterns. Innovative taxpayers purchasing the assets of a going business conceived of diverse purported asset classifications in an attempt to differentiate from goodwill what was acquired. The result was extensive litigation and a large and growing backlog of cases.[15] The major hurdle to amortization was taxpayer failure to meet the burden of proof outlined in Houston. The culmination of taxpayer efforts in this area, and a major loss for the IRS, was the recent decision of the U.S. Supreme Court in *Newark Morning Ledger v. U.S.*[16] At issue was $3 million of stipulated value of subscribers acquired in a takeover. *Newark* held the taxpayer must establish that public tastes or socioeconomic forces will cause the intangible to be retired and must establish a reasonable date by which the event will occur. If the taxpayer is able to sustain this burden of proof, the intangible can be separated from goodwill regardless of how much the intangible appears to reflect expectancy of continued patronage. At the trial, the Government presented no proof to contradict the taxpayer's experts and relied on the principal argument that as a matter of law the lists were indistinguishable from goodwill. The District Court found for the taxpayer and the 3rd Circuit reversed in favor of the Government. The Supreme Court, however, held for the taxpayer, finding that the lists were not self-regenerating - i.e., they had a limited useful life, the duration of which could be calculated with reasonable accuracy, that taxpayer properly calculated its value and that it was separate and apart from goodwill. "Petitioner has borne successfully its substantial burden of proving 'paid subscribers' constitutes an intangible asset with an ascertainable value and a limited nseful life, the duration of which can be ascertained with reasonable accuracy." It was noted, "...that burden often will prove too great to bear." The Supreme Court stated that had the Government presented credible evidence challenging taxpayer's experts, the District Court would have had a more difficult time deciding the case. Rather, the Government relied on a legal argument (i.e., the lists were indistinguishable from goodwill) which the Supreme Court rejected.[17] *Newark* seems to point up the fact that previous taxpayer losses in this area were due to evidentiary failure, in large part because of the considerable expense of establishing the evidentiary foundation and of correlative qualified expert testimony.

The loss in *Newark* and the considerable backlog of pending cases prompted the Treasury Department to seek a change in the law by way of statutory enactment.[18] Further, the existing rules were perceived as distorted in that they favored the acquisition of a business with hard assets as opposed to a service business which has primarily soft assets (e.g., customer lists, valuable employees under contract, information bases). Also, the existing rules favored created intangibles over acquired intangibles since the former arise out of currently deductible expenses (e.g., advertising, employee training, development of know-how, customer service expenditures, etc.). Finally, resource-rich taxpayers had a decided advantage in meeting the substantial burden of proving the value and the limited life of the intangible. Consequently, for the foregoing reasons, a new section (**IRC §197**) dealing with intangibles was added to the Internal Revenue Code as part of RRB '93. As will be seen, the new law is not all favorable to taxpayers. In certain cases, taxpayers may have fared better under the prior law, especially in light of *Newark*. Under the new law, however, the amortization period for prescribed intangibles is a mandatory 15 years even though a shorter period previously may have been attainable based upon the particular facts and circumstances if the taxpayer litigated the issue.

RESIDUAL ALLOCATION METHOD - IRC §1060

When the assets of a going business are acquired,[19] the price paid is often higher than the fair market value of the tangible assets. The premium paid is generally attributable to the perceived advantages of a going concern, such as, goodwill, a trained workforce, a customer base, below-market-rate lease, prime location and other assorted intangibles. In order to assure that the value assigned to tangible assets which can be depreciated, cash-equivalent intangibles (e.g., receivables) and amortizable intangibles (e.g., a covenant-not-to-compete) is not overstated, the tax law requires that the purchase price be allocated among the assets acquired using a residual method of allocation.[20] The purpose of this method of allocation is to ensure that the premium paid over and above the tangible assets and intangibles mentioned above is allocated to goodwill or going concern value which, prior to RRB '93, were not amortizable - at least in the view of the IRS.

The residual method of allocation is required when there is an "applicable asset acquisition."[21] This term is defined as meaning any transfer of assets which constitutes a trade or business and where the basis in such assets is determined by the consideration paid.[22] Treasury regulations provide that assets are deemed to constitute a trade or business if goodwill or going concern value could under any circumstances attach to the assets acquired. In making this determination all of the facts and circumstances surrounding the transaction must be taken into account.[23] Under the regulations, assets acquired are categorized by classes: Class I (cash, demand deposits and similar items); Class II (certificates of deposit, U.S. Government securities, marketable securities, foreign currency and similar items); Class III (tangible and intangible assets, such as, furniture and fixtures, land, buildings, equipment, covenant-not-to-compete and accounts receivable); and Class IV (intangible assets such as goodwill and going concern value).[24] The purchase price is first allocated to Class I assets, then to Class II assets, then to Class III

assets and anything remaining to Class IV assets. The purchase price allocated to an asset class other than Class IV cannot exceed the fair market value of that asset on the purchase date.[25] Thus, the purchase price, if any, paid over and above what is fairly allocable to the first three classes necessarily must be allocated to Class IV. Understandably, the IRS in examining a return may challenge the taxpayer's determination of the fair market value of any asset. For example, the IRS may make an independent showing of the value of goodwill and going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets.[26] So that the IRS is apprised of the allocation made when assets are acquired, the regulations contain reporting requirements.[27]

NEW INTERNAL REVENUE CODE § 197

Because of the tremendous amount of litigation pending concerning amortization of intangibles, the major loss by the Government in *Newark,* the consequent possibility of further losses and the general uncertainty and arguably unfairness of the then existing situation, the Treasury Department promoted the enactment of IRC §197 which permits the amortization of goodwill, going concern value and other prescribed intangibles over a 15-year period. Although it would appear that by sanctioning amortization of intangibles that beretofore were not amortizable the Government would be losing revenue, interestingly, IRC §197 was estimated to be a revenue raiser.[28] Apparently, mandating a 15-year write-off was perceived to be more favorable to the Government than the shorter amortization periods taxpayers were likely to obtain, in light of *Newark,* by litigation. Moreover, as will be discussed hereafter, the new treatment of covenants-not-to-compete is highly disadvantageous to taxpayers.

It is expected that the present Treasury regulations under IRC §1060 will be amended to reflect the fact that IRC §197 now allows amortization for intangibles in the nature of goodwill, going concern value and other intangibles. It is anticipated that all assets delineated in IRC §197 will be categorized as Class IV assets to be amortized over 15 years.[29]

In general, IRC §197 allows an amortization deduction with respect to the capitalized costs of any amortizable §197 intangible. As will be discussed in more detail hereafter, the term "amortizable §197 intangible" means any §197 intangible acquired and held by the taxpayer in connection with the conduct of a trade or business or an activity described in §212.[30] Thus IRC §197 applies whether the intangible is acquired separately or as part of the acquisition of the assets of a trade or business. However, as will be seen, major exceptions are applicable for certain intangibles acquired separately, and in some cases even if acquired as part of the acquisition of the assets of a trade or business. The section does not apply, however, to self-created intangibles (with some exceptions) provided such intangible is not created in connection with a transaction (or series of related transactions) that involves the acquisition of the assets of a trade or business.[31] Thus, the section does not affect the current deductibility of expenses that create intangible value (e.g. expenses for advertising, employee training, customer relations, creation of data base information systems, creation of know how, etc.). However, if the

intangible is created ancillary to the acquisition of the assets of a trade or business, then IRC §197 is applicable and such created intangible would have to be amortized over 15 years. An example of an ancillary intangible is a covenant-not-to-compete which is created concurrent with and incident to an asset acquisition. Thus, despite the fact that the covenant may run for only a few years, it will nevertheless have to be amortized over 15 years. It is important to recognize that IRC §197 is exclusive. Accordingly, taxpayers will fare worse under the new law since no depreciation or amortization is permitted for amortizable §197 intangibles except as permitted by the section.[32] On the other hand, if the asset is not an amortizable §197 intangible, the law prior to the enactment of the section would control.

Definition of "§197 Intangible." The term "amortizable §197 asset" is defined as any "§197 intangible" acquired after enactment of RRB '93 (i.e., after 8/10/93) and either held for use in business or in a §212 activity (e.g., investment). As stated, excluded are "self-created intangibles" except if created in connection with a transaction involving the acquisition of the assets of a trade or business.[33] Moreover, certain §197 intangibles are automatically considered as not self-created and consequently must be amortized over 15 years even if not acquired in connection with a transaction involving the acquisition of the assets of a trade or business.[34] In other words, certain intangibles, even if acquired or created separately, would have to be amortized over the 15-year period. Specifically, the assets required to be amortized over 15 years whether acquired separately, as part of the assets of a business, or created ancillary to the acquisition of the assets of a trade or business (e.g., a covenant-not-to-compete), are:

1. **Licenses.** Any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof.[35] Thus, the costs incurred in obtaining (or renewing) a liquor license, a taxi medallion, airport slot, regulated airline route, or television or radio broadcasting license are amortizable over 15 years even if the right is granted for an indefinite period or the right is reasonably expected to be renewed for an indefinite period.[36] Previously, the IRS was generally successful in barring amortization of these items, despite the fact that the license was for a fixed period, unless the taxpayer could prove that the license was unlikely to be renewed.

2. **Covenants-Not-To-Compete and Similar Arrangements.** As mentioned, the Government expects IRC §197 to he an overall revenue raiser and this is accomplished only because the section is bad news for taxpayers in certain cases. The most noteworthy example is an amount paid for a covenant-not-to-compete (or other arrangement to the extent such arrangement has the same effect as a covenant-not-to-compete) entered into in connection with the acquisition (directly or indirectly) of an interest in a trade or business.[37] Although often created incident to an asset acquisition, a covenant is not part of the assets of the business acquired. Under prior law, if part of the purchase price of the business was allocated to a *bona fide* covenant, the allocated amount could be amortized over the life of the covenant, which typically ran for no more than 5 years. Accordingly, there was an incentive to allocate to a covenant rather than non-amortizable goodwill. Of course, whether the amount allocated was bona fide or simply a scheme to amortize what

was substantively goodwill was a matter to be resolved based upon the particular facts and circumstances. For example, an amount paid to a 70-year old retiring seller moving to another part of the country (who clearly had no intention of competing) for his covenant would no doubt have been characterized by the IRS as in substance a payment for goodwill if it became aware of the facts. Now, under the new law, despite the actual term of the covenant, the allocated amount must be amortized over 15 years. This is true whether the amount is paid to the corporation selling the assets and/or directly to the principals involved.[38] Accordingly, it should now make no difference to the buyer whether an amount is allocated to goodwill or a covenant since both are amortizable over 15 years. However, it may make a difference to the seller.[39] Obviously, the new rules prevent taxpayer deception in this area.

As stated, the initial payment under a covenant is to be amortized over 15 years. However, subsequent payments (such as, contingent payments geared to gross revenue or earnings), if any, are to be amortized ratably over the remaining months in the initial 15-year amortization period as of the beginning of the month that the subsequent amount is paid or incurred.[40]

Generally, IRC §197 is not applicable to a stock acquisition (unless a deemed election under IRC §338 is made). However, amortization of a covenant over 15 years is required where it is paid for separately (to the stockholders) ancillary to a stock acquisition or the acquisition of an interest in a partnership.[41]

In both asset and stock acquisitions, it was commonplace to enter into a management or consulting agreement (employment arrangement) with the former owner(s) of the business. In many cases, the employment arrangement was a sham with the contracted consultant and/or manager rendering little or no services. The obvious purpose underlying this type of pretextual allocation was to carve out an amount that would otherwise be allocable to non-amortizable goodwill (or a covenant to be amortized over a period of time) and get an immediate deduction for the payments under the employment arrangement. To prevent abuse in this area, IRC §197(d)(1)(E) refers to arrangements that have "substantially the same effect as a covenant." Accordingly, the Government will scrutinize arrangements that require the former owner(s) of a business to provide services to the business, or to lease property to it, to ensure that the arrangements are bona fide and that the amounts paid to the former owners are reasonable. To the extent compensation paid under an employment arrangement to the former owner(s), or lease payments, are not reasonable, they will be constructively considered as payments for a covenant-not-to-compete.[42] Accordingly, rather than an immediate deduction for compensation and/or lease payments, amortization over 15 years will be required for such payments. As under present law, to the extent that an amount paid for a covenant (or similar arrangement) is substantively additional consideration for stock, such amount cannot be amortized under the new law but, instead, is to be added to the acquirer's basis in the stock.[43] Consequently, it is clear that the IRS will carefully scrutinize employment arrangements and covenants entered into ancillary to a stock acquisition to determine whether they are bona fide.

3. **Franchises, Trademarks and Trade Names.** IRC §197 defers to IRC §1253(d)(1) if the latter provision governs the treatment of these items.[44] If it does not, IRC §197 is applicable. IRC §1253(d)(1) deals with contingent payments and permits immediate deductibility of franchise payments contingent on the productivity, use or disposition of the franchise, trademark or trade name that are paid as part of a series of payments paid not less than annually throughout the term of the franchise agreement, including renewals, and which are substantially equal in amount, or paid under a fixed formula. Prior to RRB '93, lump sum payments were deductible over 10 years; any other payments (i.e., not formula based, substantially equal or lump sum) had to be capitalized and amortized over 25 years.

IRC §197 defers only to the provisions of IRC §1253(d)(1) which deal with contingent payments based on a formula or payments that are substantially equal. Thus, an immediate deduction for such payments is continued. However, lump sum payments that were deductible over 10 years and other payments not formula based or substantially equal, which heretofore were amortizable over 25 years, are now amortizable over 15 years. If payments (not formula based or substantially equal) relating to the original issuance of the franchise, etc., are paid in following years, they are to be amortized over the period remaining in the 15-year period. However, payments to renew a franchise, etc., would start a new 15-year period running.[45] For purposes of defining the term "franchise," IRC §197 defers to IRC §1253(b)(1).[46]

Specific §197 Intangible Classifications. As mentioned, taxpayers over the years have been resourceful in creating and carving out from goodwill allegedly separate categories of assets which were then asserted to have a limited life and thereby were amortizable. Consequently, the Government appears to have attempted to bring within the scope of IRC §197 a myriad of classifications, no doubt based upon its experiences with taxpayer creativity. Thus, the term "§197 intangible" includes:[47] (i) goodwill, (ii) going concern value, (iii) workforce in place, including composition and terms and conditions of employment, (iv) information base, including business books and records, operating systems, or any other information base such as lists or other information with respect to current or prospective customers, (v) any patent, copyright, formula, process, design, pattern, know-how, format or similar item, (vi) any customer-based intangible, including composition of market, market share and any other value resulting from future provision of goods and services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers; and for financial institutions, deposit base and similar items, (vii) any supplier-based intangible, defined as any value resulting from future acquisition of goods and 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, (viii) any item similar to (iii) to (vii) (as a catchall), (ix) any license, permit or other right granted by a governmental unit or an agency or instrumentality thereof (not included if acquired separately is any right to receive tangible property or services under a contract granted by a governmental unit or agency or instrumentality thereof), (x) a covenant not to compete (or other arrangement substantially the same) entered into in

connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and (xi) any franchise, trademark or tradename.

Goodwill and Going Concern Value. Goodwill is the expectation of continued customer patronage whether due to the name of the business, reputation or any other factor. Going concern value is purportedly the additional value of a business attributable to the fact that it is a going concern that can function and generate income despite a change of ownership. Additionally, the value of earnings that would otherwise not be available if the business were not operational are part of going concern value.[48] Is there really a distinction between goodwill and going concern value? The fact that a business can successfully survive a change in ownership and that it is expected to produce earnings is arguably attributable to expected customer patronage.

Workforce, Information Base, Know-How, Customer-Based Intangibles, Supplier-Based Intangibles and Other Similar Items. The new law evidently attempts to address every element of value that might be envisioned by creative taxpayers involved in the acquisition of the assets of a going business. There are obviously many reasons why more than the value of the tangible assets may be paid for a going business. No doubt the Government in the administration of the tax laws and in litigation has come across the foregoing items which taxpayers have carved out in an attempt to obtain amortization deductions.

Workforce. It is recognized that an experienced, educated and trained workforce in place is a valuable element of a business. Therefore, if any part of the purchase price of a business is attributable to a highly-skilled workforce, to acquiring an existing employment contract or to acquiring an important relationship, such as with a "key employee," such part of the purchase price must be amortized over 15 years.[49]

Information Base. Much litigation has been spawned by taxpayer attempts to amortize items that may be classified as "information base."[50] Included under this caption are customer lists (whether current or prospective), technical and training manuals, data files, accounting or inventory systems, insurance expirations, patient or client files, subscription lists and lists of advertisers in the newspaper, magazine, radio and television industries. All of the foregoing to which value may be ascribed when acquiring a business must be amortized over 15 years.[51]

Know-How. If value is ascribed to what is commonly categorized as "know how," such value must be amortized over 15 years. Included are patents, copyrights, formulas, processes, designs, patterns, package designs, computer software and any interest in a film, sound recording, video tape, book or similar property. However, there is an important exception for patents and copyrights as further explained hereafter.[52]

Customer- and Supplier-Based Intangibles. Value attributed to "customer-based" and "supplier-based" intangibles must also be amortized over 15 years. Customer-based intangibles refers to value assigned to composition of market, market share, or any relationship with customers (contractual or otherwise). More specific examples are:

Insurance in force, mortgage servicing contracts, investment management contracts or other relationships with customers involving the future provision of goods or services. Insofar as financial institutions are concerned, included are deposit base and any value relative to checking accounts, savings accounts and escrow accounts, for example. All of the foregoing must be amortized over 15 years. However, it is made clear that the portion of the purchase price of the assets of a business allocable to accounts receivable or any similar right to income is not covered under the new law.[53] Value attributed to supplier-based intangibles acquired with the assets of a business must also be written off over the 15-year period, examples being the existence of a favorable relationship with persons that provide distribution services (such as, favorable shelf or display space at a retail outlet), the existence of a favorable credit rating and the existence of favorable supply contracts.[54]

Catch-all. The authors of IRC §197 recognized that in drafting the section they may not have set forth every conceivable element of value that might arise in connection with the acquisition of the assets of a business (or that might be acquired separately). Accordingly, the term "§197 intangible" is also defined to include any other property similar to workforce, information base, know-how, customer-based intangibles or supplier-based intangibles.[55]

Although the foregoing items are usually acquired in connection with (or created incident to) the acquisition of the assets of a trade or business, it is important to recognize that even if acquired separately (if feasible), IRC §197 would be applicable. However, it appears that a separately created covenant-not-to-compete would not be covered by IRC §197 since the pertinent part of the section refers to a covenant entered into in connection with the acquisition (directly or indirectly) of an interest in a trade or business.[56] For example, an amount might be paid to a resigning employee for his contractual agreement not to compete for a period of time. Since not incident to the acquisition of an interest in a trade or business, it appears that such a payment would be amortizable over its term.

Since the cost of acquiring the above intangibles must be amortized over 15 years, it may be more economically viable to develop such intangibles. For instance, the costs of training a work force and developing an information base, know how and customer and supplier-based intangibles would be deductible currently.

Exceptions.[57] The term "§197 intangible" does not include the following items:

(i) financial interests in a corporation, partnership, trust, or estate, or under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract,

(ii) land,

(iii) computer software readily available to the general public, subject to a nonexclusive license, and not substantially modified, and other computer software provided not acquired in a transaction involving the purchase of the assets of a trade or business. The term "computer software" does not include a data base or similar item

unless the data base is in the public domain and is incidental to the operation of otherwise qualifying computer software, and

(iv) certain interests or rights acquired separately and not acquired in a transaction (or series of related transactions) involving the acquisition of the assets of a trade or business. This category includes (I) any interest in a film, sound recording, video tape, book or similar item, (II) any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof, (III) any interest in a patent or copyright, (IV) to the extent provided in regulations, any right under a contract (or granted by a governmental unit or agency or instrumentality thereof) if such right has a fixed duration of less than 15 years, or is fixed as to amount and, without regard to IRC §197, would be recoverable under a method similar to the unit-of-production method.

(v) certain interests under existing leases and indebtedness.

(vi) a franchise to engage in professional sports, and any item connected therewith.

(vii) residential mortgage servicing contracts (provided not acquired in connection with the acquisition of the assets of a trade or business), and

(viii) fees for professional services, and any transaction costs incurred in connection with tax free reorganizations.

Interests in a Corporation, Partnership, Trust or Estate. The new law does not apply to the cost of acquiring an interest in these entities, even though they are intangibles, whether or not such interests are traded on an established market.[58] Accordingly, if you buy stock in a corporation paying a premium over the value of the tangible assets owned by the corporation, no amortization of such premium is permitted (unless a deemed asset election is made under IRC §338). Intangibles on the books of the corporation acquired prior to the new law would continue to be amortized, if amortizable at all, under whatever method was extant.

Interests Under Certain Financial Contracts. The term "§197 intangible" does not include such items as: An interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract, whether or not regularly traded on an established market.

Interests in Land. The cost of acquiring land is to be taken into account under present law. Included in this category are fee interests, life estates, remainders, easements, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, and similar rights with respect to land. However, an interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television. These items apparently will be amortizable over 15 years. The cost of licenses and permits relating to building construction are to be accounted for in accordance with prior law (i.e., part of the cost of the property).[59] As under prior law, no amortization or depreciation is allowed for land.

Computer Software. Software the public can buy that is subject to a non-exclusive license (typically store-bought or mail order software), and not substantially modified, is not a §197 intangible, whether acquired as part of the assets of a trade of business or

otherwise. If such software is not currently deductible under IRC §174 (Research and Experimental Expenditures) or amortizable over the depreciation period of the associated hardware where the cost is not separately stated,[60] it is to be amortized over 36 months beginning in the month placed in service.[61] Other computer software that is purchased as part of the assets of a trade or business is a §197 intangible, whereas if purchased separately it is not a §197 intangible. The term "computer software" is defined as any program designed to cause a computer to perform a desired function. However, it does not include a data base or similar item unless the data base is in the public domain and is incidental to the operation of the software.[62] An example of an incidental data base would be a dictionary or thesaurus. Since a data base (not in the public domain and incidental) acquired separately is not within the exception, it is a §197 intangible and subject to 15-year amortization. Other computer software acquired separately can be written off over 36 months.[63]

What is meant by "readily available to the public," "not substantially modified," and "in the public domain?" Unless clarified by regulations, these terms, which call for factual determinations, will sooner or later result in disagreement between taxpayers and the Government.

Since certain computer software acquired as part of the assets of a trade or business, and even a data base acquired separately, would have to be amortized over 15 years, a leasing arrangement may be preferable.

Separately Acquired Rights. The new law has numerous exceptions to the definition of a §197 intangible, provided the intangible is not acquired along with the assets of a trade or business or a substantial portion thereof. However, it is expected that regulations will address the situation where the separately acquired intangible is in and of itself a trade or business.[64] Facts and circumstances will determine whether acquired assets constitute a substantial portion of a trade or business. However, the value of assets acquired relative to the value of assets retained by the transferor will not be determinative. For purposes of determining whether a group of assets constitutes a trade or business, IRC §197 defers to IRC §1060 (i.e., if goodwill or going concern value attach to the assets acquired). Importantly, as noted above, the acquisition of a franchise, trademark, tradename or license automatically is deemed to constitute the acquisition of a business.[65] Under these rules, it is clear that the acquisition of even a single intangible asset could be a trade or business requiring 15-year amortization, thereby eviscerating the separately acquired asset exception. The Government is aware of the possibility of manipulation of the new rules by splitting up assets among related parties. Accordingly, in determining whether an acquired intangible asset is part of a trade or business, assets acquired by the taxpayer (and persons related to the taxpayer) from the same person (and related persons) are to be taken into account. Moreover, continuation of employee relationships and covenants-not-to-compete are to be considered in determining whether the transferred assets constitute a trade or business.[66]

- *Rights to Receive Tangible Property or Services.* Provided not acquired together with the assets of a trade or business, any right to receive tangible property or services granted by any governmental unit is not a §197 intangible. If a depreciation deduction is allowed for such rights, it will be determined by regulations to be promulgated by the Treasury Department. It is expected that if a non-renewable right is acquired, it will be amortizable over its life. With respect to a right to receive a fixed amount of tangible property or services, it is expected that amortization for the taxable year of the cost of acquiring the right will be based upon the relative value received during the year to the total value to be received under the right. It is also expected that the regulations, in appropriate circumstances, will require amortization of the cost of acquiring a renewable right over a period that includes all renewal options exercisable at less than fair market value.[67] Note that this exception pertains only to the right to receive tangible property or services. Thus, the exception does not cover the right to receive intangible property, such as know how.

- *Any Interest in a Patent or Copyright.* Patents and copyrights not acquired with the assets of a trade or business are not a §197 intangible. The amortization period of such items will be determined in accordance with Treasury Department regulations to be promulgated.[68] It is expected that the regulations will provide that if the purchase price of a patent is payable on an annual basis as a fixed percentage of revenue, that the depreciation deduction will be equal to the amount of royalty paid or incurred.[69]

- *Regulations Regarding Rights of Fixed Term or Duration.* Regulatory authority is granted to the Treasury Department to issue regulations excluding a contract right (whether to receive tangible or intangible property or services), including one granted by a governmental unit, from the definition of §197 intangible if the right is not acquired in connection with the assets of a trade or business, and the right has either (A) a fixed duration of less than 15 years, or (B) is fixed as to amount and the cost is properly recoverable under a method similar to the unit-of-production method. An example is an emission allowance granted to a public utility under Title IV of the Clean Air Act Amendments of 1990 since each allowance grants a right to a fixed amount of emissions. It is anticipated that in determining whether a contract is of fixed duration, the mere fact that the taxpayer will have the opportunity to renew on the same terms as others in a competitive auction in which the taxpayer does not have any advantage will not be taken into account. The facts and circumstances relative to an actual practice of renewals or expectancy of renewals will also be considered in determining whether a contract is of fixed duration. The regulations are also to prescribe rules concerning the extent to which renewal options are to be considered in determining whether rights are fixed as to duration or amount. Finally, such regulations are to prescribe the method of amortizing the cost of rights excluded from the definition of §197 intangible.[70]

Certain Interests Under Existing Leases and Indebtedness. The term §197 intangible does not include any interest as a lessor or lessee (or sublessee) under any existing lease of tangible personal property (real or personal). For example, the portion of the purchase

price of an office building attributable to favorable leases is excluded and is to be taken into account as part of the basis of the office building and depreciated accordingly. The cost of acquiring an interest as a lessee under an existing lease of tangible property is to be taken into account under existing law,[71] even if acquired with other assets of a trade or business. An example is a lease of a gate at an airport for the purpose of loading and unloading passengers and cargo. An interest as a creditor or debtor under any indebtedness in existence when the interest was acquired is also excluded. So, the value of an existing indebtedness because of a below-market interest rate is to be taken into account under prior law (i.e., over the term of the debt). A premium paid to acquire a debt with an above-market interest rate is to be taken into account under IRC §171 (amortization on a yield to maturity basis). The exception for existing indebtedness does not apply to the deposit base and other similar items of a financial institution for which 15-year amortization is apparently required.[72]

Professional Sports Franchises. Excluded are any franchise to engage in any professional sport, and any item acquired in connection with such franchise. Consequently, the cost of such franchise and related assets (including goodwill, going concern value, or other §197 intangibles) is to be allocated among the assets acquired as provided under prior law (i.e., under IRC §1060) and is to be taken into account under provisions of prior law.[73] This means that the purchase price allocable to the franchise and related assets may not be amortized (unless successfully litigated).[74] Player contracts, however, are a §197 intangible. Presumptively, no more than 50% of the consideration paid may be allocated to player contracts unless the taxpayer can convince the IRS that more should be allocable.[75]

Mortgage Servicing Contracts. Mortgage servicing contracts are any right to service debt secured by residential property. They are not covered under IRC §197 unless acquired with the assets of a trade or business.[76] If acquired separately, they can be amortized over 9 years.[77]

Transactional Costs. Excluded are the amount of professional fees paid in connection with corporate organizations and reorganizations. Organization costs are amortizable over 60 months.[78] Costs of a reorganization required to be capitalized have historically not been deductible nor amortizable because such costs do not relate to any asset with a readily identifiable useful life. The exception is provided solely to clarify that IRC §197 is not to be construed as allowing 15-year amortization for reorganization costs.[79]

Loss on Disposition. If a taxpayer disposes of an acquired §197 intangible and retains other §197 intangibles acquired in the same (or a series of related transactions), no loss on the disposition is allowed. Rather, the adjusted bases of the retained intangibles are to be increased by the disallowed loss in proportion to the relative amount of the bases of the retained intangibles. For purposes of this rule, corporations that are a member of a controlled group are treated as one person. Thus, one member of the controlled group cannot take a loss deduction on disposition of an acquired intangible if another member of the controlled group retains an intangible(s) acquired in the same transaction. It is

expected that the Treasury Department will promulgate regulations permitting the loss on the disposition in such case to be amortized over the remaining time in the 15-year period.[80]

Abandonment. Greatly ameliorating the requirement of amortization over 15 years is the fact that abandonment of a §197 intangible or any other event that renders such intangible worthless is to be considered a disposition. Accordingly, if a §197 intangible is separately acquired, its unamortized cost may be written off if it is abandoned or becomes worthless. However, in no event can the worthlessness of a portion of a §197 intangible be considered the disposition of a separately acquired §197 intangible. For instance, the termination of one or more customers from a customer list or the worthlessness of some information from a data base is not to be considered the disposition of a separately acquired §197 intangible. Query? Will a write-off of the unamortized cost of a customer list be permitted where every customer on the original list is no longer on it? Hopefully, regulations will clarify this point. Of course, as noted, if one of a number of acquired intangibles becomes worthless or is abandoned, the unamortized cost would have to be allocated among the retained intangibles and no loss deduction would be permitted unless everything acquired in the same transaction was abandoned or became worthless.[81] Thus, it would appear, for example, that if an amount is allocated to goodwill and a covenant-not-to-compete for 5 years, both arising out of the same asset acquisition, both items would have to be amortized over 15 years. No loss deduction would be allowed for the unamortized cost of the covenant when it became worthless upon the expiration of the 5-year term; rather, such unamortized cost would have to be added to the unamortized basis of the goodwill and amortized along with it over the time remaining in the 15-year period. With respect to a covenant-not-to-compete created incident to a stock acquisition, it is made clear that the covenant will not be considered worthless or abandoned unless the stock becomes worthless, or all of the businesses acquired through the stock acquisition are also disposed of or become worthless.[82]

Not a Capital Asset. An amortizable §197 intangible is to be treated as depreciable property and consequently is not a capital asset. Thus gain or loss on disposition will be treated under IRC §1231 and any gain on disposition will be subject to recapture as ordinary income pursuant to IRC §1245, and IRC §1239 will apply to any gain recognized on a sale or exchange between related persons.[83]

Anti-Churning Rules. IRC §197 contains special rules to prevent taxpayers from converting existing intangibles that were not amortizable under prior law into amortizable property under the new law.[84] The anti-churning rules apply back to July 25, 1991. The rules address the following situations: (a) the taxpayer or a related person used the intangible at any time beginning on July 25, 1991, and ending on the date of enactment of the new law (i.e., after 8/10/93), (b) the taxpayer acquired the intangible from a person that held such intangible at any time beginning on July 25, 1991, and ending on the date of enactment 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) at any time during the period beginning on July 25, 1991, and ending on the date

of enactment. In the above situations, the intangible in question will not be considered an amortizable §197 intangible. However, the anti-churning rules do not apply to inherited intangibles.[85] Relationships will be determined pursuant to IRC §§ 267(b)(1), 707(b)(1), relaxing ownership by substituting 20% for 50%, and 41(f)(1). Further details on the anti-churning rules are contained in the Conference Report.[86] Further, to make sure that ingenious taxpayers are not permitted to somehow circumvent the anti-churning rules or otherwise avoid the requirement that only intangibles acquired after the date of enactment of the new law may be amortized, a general anti-abuse provision is part of the new law.[87]

Certain Transfers. If the transferor of any §197 intangible is not allowed an amortization deduction with respect to any property classified under the new law, then the transferee of the property will not be allowed to amortize the property to the extent the transferee's basis is determined by reference to the transferor's basis pursuant to certain non-recognition transaction.[88]

CONCLUSION

With the enactment of IRC §197, the Government has taken a major step in eliminating and simplifying a very controversial area of the tax law. The Government was concerned about the severe backlog of cases in this area pending in audit and litigation. Accordingly, the IRS was urged in the strongest possible terms to expedite the settlement of cases that arose under the old law. To this end, the IRS was encouraged to take into account the principles of the new law so as to produce consistent results for taxpayers similarly situated.[89] Hopefully, since more than a year has gone by since enactment of the new law and the writing of this article, the IRS has made a dent in the backlog. Although the new law was enacted to simplify a controversial area, IRC §197 is not so simple, as the foregoing analysis clearly shows. As previously noted in a number of instances, the Treasury Department has been directed to issue explanatory regulations. Further, regulatory authority is specifically given to the Treasury Department to promulgate regulations as may be appropriate to prevent avoidance of the purposes of the new law through related persons or otherwise.[90] Since IRC §197 is lengthy and obviously intricate, it is certain that taxpayers can look forward to regulations that will be protracted and complex.

In determining whether the purchase of the assets of a going business makes economic sense, the fact that intangibles that heretofore were not amortizable (at least not without a fight) may now be amortized will, of course, have to be considered. Consequently, deals that were not financially feasible may now be so due to the reduced economic cost of acquiring such intangibles.

ENDNOTES

[1] Bulletin F - 1942.

[2] Rev. Proc. 62-21, 1962-2 CB 418.

[3] 1971 Revenue Act, P.L. 92-178.

[4] Economic Recovery Tax Act of 1981, P.L. 97-34.

[5] Tax Reform Act of 1984, P.L. 98-369.

[6] Public Law 99-21 (1985).

[7] Tax Reform Act of 1986, P.L. 99-514.

[8] Revenue Reconciliation Bill of 1993, P.L. 103-66, effective for commercial real estate acquired after May 13, 1993. The Revenue Reconciliation Bill is referred to herein as RRB '93.

[9] *For exceptions see, e.g.,* IRC § 178 (lease acquisition costs); IRC §174 (research and experimental expenditures); IRC §248 and IRC §709 (organizational expenses) and IRC §195 (start-up expenses). References herein to "IRC §" are to the applicable sections of the Internal Revenue Code of 1986, as amended.

[10] Treas. Reg. § 1.167(a)-3 (1960). References herein to "Treas. Reg. §" are to the applicable sections of the Treasury Regulations under the Internal Revenue Code of 1986.

[11] *See, e.g., Daniel J. Klein v. Comm.,* TC Memo 1965-207, *aff'd per curiam* 372 F.2d 261 (2d Cir. 1966).

[12] *Panichi v. U.S.*, 834 F.2d 300 (2d Cir. 1987).

[13] *Houston Chronicle Publishing Co. v. U.S.,* 481 F.2d 1240, 1249 (5th Cir. 1973), *cert. denied* 414 U.S. 1129 (1974)

[14] Rev. Rul 74-456, 1974-2 CB 65.

[15] In 1991, the General Accounting Office estimated that there were $8 billion in deficiencies asserted against taxpayers attempting to amortize intangibles (GGD-91-88, *"Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets, "* (8/9/91)). A later estimate upped the ante to $14.4 billion of asserted adjustments related to amortization of intangible that were either in the audit or litigation pipeline (*Tax Notes Today* (10/4/93)).

[16] *Newark Morning Ledger Co. v. U.S.,* 945 F.2d 555 (3rd Cir. 1991), *rev'd* 113 S.Ct. 1670 (1993).

[17] Certiorari was granted in Newark to settle a perceived conflict in the circuit courts. *See, e.g., Donrey, Inc. v. U.S.,* 809 F.2d 534 (8th Cir. 1987) and *Citizens and Southern Corp. v. Comm.,* 91 TC 463 (1988), *aff'd* 919 F.2d 1492 (11th Cir. 1990).

[18] Conference Report, at 211 and 232. All references to the " Conference Report" berein are to the Conference Report on the RRB '93, H.R. Rep. No. 103-213, P.L. 103-66 (1993). Page references are to the Commerce Clearing House version of the Report (CCH Special 10).

[19] As most legal and tax advisers are aware, it is generally preferable to purchase the assets of a business rather than the stock of the corporation owning the assets since with a stock acquisition the purchaser is acquiring the corporate liabilities, known, unknown and contingent.

[20] IRC §1060.

[21] IRC §1060(a).

[22] IRC §1060(c).

[23] Temp. Treas. Reg. §1-1060-1T(b)(1). Facts and circumstances to be considered under the Regulations are an excess of total consideration over the aggregate book value of the tangible and intangible assets acquired, other than goodwill and going concern value, as shown in the financial and accounting records; and related transactions, including lease agreements, licenses, covenants-not-to-compete, employment contracts and similar arrangements between the purchaser and seller (or managers, directors, owners, or employees or the seller).

[24] Temp. Treas. Reg. §1.1060-T(d)(2).

[25] Temp. Treas. Reg. §1.1060-T(e)(1).

[26] Temp. Treas. Reg. §1.1060-T(e)(4).

[27] Temp. Treas. Reg. §1.1060-T(h). Form 8594, Asset Acquisition Statement, is required to be completed for any applicable asset acquisition and attached to the applicable tax form.

[28] The text of the Conference Report explaining §197 is contained in the revenue raising part of the Report.

[29] Conference Report, at 231.

[30] IRC §197(c). The section also applies to a stock purchase treated as an asset acquisition under

IRC § 338.

[31] IRC §197(c)(2)(B). IRC §197 expands on the term " trade or business" to include a "substantial portion thereof."

[32] IRC §197(b).

[33] IRC §197(c)(2)(B).

[34] IRC §197(c)(2)(A).

[35] IRC §197(d)(1)(D).

[36] Conference Report, at 215.

[37] IRC §197(d)(1)(E).

[38] In many cases a covenant-not-to-compete is obtained both from the corporate seller of the assets and the owners of the corporation. Usually, any consulting or employment agreement is entered into directly with the owners.

[39] However, as under prior law, it may make a difference to the seller since the amount received for selling goodwill qualifies for capital gain treatment whereas the amount receive for a covenant is ordinary income.

[40] Conference Report, at 216.

[41] *See* reference in IRC §197(d)(2)(E) of language "directly or indirectly" and Conference Report, at 216.

[42] Conference Report, at 216.

[43] *Id.*

[44] IRC §197(f)(4)(C).

[45] IRC §197(f)(4)(B).

[46] IRC §197(f)(4)(A).

[47] IRC §197(d) lists the various IRC §197 intangible assets.

[48] Conference Report, at 213.

[49] *Id.,* at 213.

[50] *See* Newark, *supra.*

[51] Conference Report, at 213-214.

[52] *Id.,* at 214.

[53] *Id.,* at 214.

[54] *Id.,* at 215.

[55] *Id.,* at 215.

[56] IRC §197(d)(1)(E).

[57] The exceptions to IRC §197 intangibles is contained in IRC §197(e).

[58] Conference Report, at 218.

[59] *Id.,* at 219

[60] *See* Rev. Proc. 69-21, 1969-2 CB 303.

[61] IRC §167(f)(1), as added by RRB '93; Conference Report, at 220.

[62] IRC §197(e)(3)(B).

[63] IRC §167(f)(1), as added by RRB '93.

[64] Conference Report, at 217.

[65] *Id.,* at 218.

[66] *Id.*

[67] *Id.,* at 220-221

[68] IRC §167(f)(2).

[69] Conference Report, at 221; *See* Associated Patentees, Inc., 4 T.C. 979 (1945) and Rev. Rul. 67-136, 1967-1 C.B. 58.

[70] Conference Report, at 223-225; IRC 167(f)(2), as added by RRB '93.

[71] *See* IRC §178 and Treas. Reg. § 1.162-11(a).

[72] Conference Report, at 221-223.

[73] *Id.,* at 223.

[74] *See* Committee Report to 1976 Tax Reform Act, P.L. 94-455 (1976), 1976-3 CB 49, 807.

[75] IRC §1056(d).

[76] IRC §197(e)(7).

[77] IRC §167(f)(3). *Also, see* IRC §1286 and the Conference Report, at 237. *Also, see* Conference Report, at 229, regarding assumption reinsurance contracts.

[78] IRC §248.

[79] Conference Report, at 223.

[80] *Id.,* at 226.

[81] *Id.*

[82] *Id.,* at 237-238; IRC §197(f)(1)(B).

[83] Conference Report, at 230.

[84] IRC § 197(f)(9).

[85] IRC §197(f)(9)(D).

[86] Conference Report, at 234-235.

[87] IRC §197 (f)(9)(A); Conference Report, at 235-236.

[88] Conference Report, at 236; IRC §197(f)(2).

[89] *Id.*, at 232.

[90] IRC §197(g).