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THE BATTLE OVER THE DEPRECIABILITY OF GOODWILL: WAS THE VICTORY WORTH THE WAIT?

Newark Morning Ledger Co. v. United States
113 S. Ct. 1670 (1993)

Tammy L. Barham

I. INTRODUCTION

If an intangible asset is known from experience or other factors to be of use in [a] 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. . . . *No deduction for depreciation is allowable with respect to goodwill.*¹

As is tried and true, this simple, broad language set forth by the Internal Revenue Service [hereinafter IRS] as a “clarification” of the Internal Revenue Code [hereinafter Code] has caused an endless amount of litigation, leading to confusion among courts of law and disparate treatment of taxpayers.²

1. Treas. Reg. § 1.167(a)-3 (as amended in 1960) (emphasis added).

2. Compare *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987) (allowing depreciation of a purchased newspaper's subscription list); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446 (Ct. Cl. 1976) (allowing depreciation of purchased insurance expirations); *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973) (allowing depreciation of a purchased newspaper's subscription list), *cert. denied*, 414 U.S. 1129 (1974); *Colorado Nat'l Bankshares, Inc. v. Commissioner*, 60 T.C.M. (CCH) 771 (1990) (allowing depreciation of purchased banks' deposit base), *aff'd*, 984 F.2d 383 (10th Cir. 1993); *Citizens & S. Corp. v. Commissioner*, 91 T.C. 463 (1988) (allowing depreciation of deposit base), *aff'd per curiam*, 919 F.2d 1492 (11th Cir. 1990); *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223 (1975) (allowing depreciation of purchased credit reporting business' customer files) *with* *Boe v. Commissioner*, 307 F.2d 339 (9th Cir. 1962) (denying depreciation of a purchased medical practice's medical service contracts); *Dodge Bros. v. United States*, 118 F.2d 95 (4th Cir. 1941) (denying depreciation for the loss of goodwill due to obsolescence); *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926) (denying depreciation for the obsolescence of goodwill), *cert. denied*, 273 U.S. 763 (1927).

As the Second Circuit has noted: “In the realm of intangibles . . . the rulings and decisions are in a state of hopeless confusion. . . . The taxpayer, who may be exposed to interest and penalties for guessing wrong, is entitled to reasonably clear criteria or standards to let him know what his rights and duties are.” *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973).

The United States Supreme Court has finally laid to rest the enduring controversy³ created through the years as a result of courts trying to balance the idealism of sustaining a long-standing, traditional law against the rationality of applying that law. *Newark Morning Ledger Co. v. United States* answers the fervently-disputed question⁴ of whether goodwill is nondepreciable as a matter of law, or whether it is subject to depreciation once it has been determined to have a reasonably-estimated useful life.⁵

In essence, goodwill is an intangible value which attaches to a business as a result of the favorable reputation that business has gained with its customers.⁶ As one might expect, this "favorable reputation" can be very valuable in monetary terms in certain customer-driven industries such as the banking, insurance, newspaper and other print media, and health care industries. However, in the past there has been no tax benefit to be derived from owning a valuable asset labeled "goodwill."⁷

Section 167(a) of the Code allows taxpayers to reduce their current federal income tax liability in the form of annual depreciation deductions allowed for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or

3. For commentary on the subject, see, e.g., Martin J. Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 TAX LAW. 251 (1975); Alan Gunn, *The Requirement That a Capital Expenditure Create or Enhance an Asset*, 15 B.C. INDUS. & COM. L. REV. 443 (1974); Danny P. Hollingsworth & Walter T. Harrison, *Taxation of Intangibles*, 9 J.L. & COM. 51 (1989); Marc D. Levy et al., *Supreme Court's Decision on Amortizing Intangibles Removes One Barrier*, 79 J. TAX'N 4 (July 1993); Robert J. McDonald, *Goodwill and the Federal Income Tax*, 45 VA. L. REV. 645 (1959); George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179 (1987); Alan S. Schenk, *Depreciation of Intangible Assets: The Uncertainty of Death and Taxes*, 13 WAYNE L. REV. 501 (1967); Robert W. Wyndelts & Anna C. Fowler, *Avoiding Allocations to Goodwill Under the Asset-Acquisition Rules*, 71 J. TAX'N 392 (1989); Note, *An Inquiry into the Nature of Goodwill*, 53 COLUM. L. REV. 660 (1953); John L. Cleary, II, Comment, *Core Deposit Base: Goodwill or Not Goodwill—Is That the Question?*, 39 CATH. U. L. REV. 795 (1990); Comment, *Depreciability of Going Concern Value*, 122 U. PA. L. REV. 484 (1973); J. Tyler Haahr, Note, *Core Deposit Base: A Depreciable Intangible or Goodwill*, 41 TAX LAW. 867 (1988); Daniel P. Meehan, Note, *Core Deposit Intangibles and Amortization: Citizens & Southern Corp. & Subsidiaries v. Commissioner*, 44 TAX LAW. 577 (1991); Linda J. Pissott, Note, *The Amortization of Customer-Based Intangibles: The "Separate & Distinct from Goodwill" Requirement and H.R. 3035's Proposal for Change*, 45 TAX LAW. 1031 (1992); Allen Walburn, Comment, *Depreciation of Intangibles: An Area of the Tax Law in Need of Change*, 30 SAN DIEGO L. REV. 453 (1993).

The depreciability of intangible assets has also been a source of legislative debate. Compare H.R. 563, 102d Cong., 1st Sess. (1991) (proposing the disallowance of depreciation deductions for all customer-based intangibles) and H.R. 3545, 100th Cong., 1st Sess. (1987) (proposing that depreciation deductions for customer-based intangibles be denied) with H.R. 13, 103d Cong., 1st Sess. (1993) (advocating the allowance of depreciation over a specified period of time for intangible assets). This legislative debate ended on August 10, 1993, when the Omnibus Budget Reconciliation Act of 1993, including the Revenue Reconciliation Act of 1993, was signed into law by President Clinton. Pub. L. No. 103-66, 107 Stat. 312 (1993). Section 197, entitled "Amortization of Goodwill and Certain Other Intangibles," was added to the Code by the 1993 Act. Omnibus Budget Reconciliation Act of 1993, tit. XIII, ch. 1, subchapter B, pt. VI, Pub. L. No. 103-66, § 13261, 107 Stat. 312, 532-40 (1993).

4. See *supra* note 3.

5. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1672 (1993). According to *Black's Law Dictionary*, tangible assets are depreciated, while intangible assets are amortized. *Id.* at 1683 n.1 (Souter, J., dissenting) (citing BLACK'S LAW DICTIONARY 83, 441 (6th ed. 1990)). However, the statute and regulations use only the term depreciation. *Id.* For that reason, I use the term depreciation interchangeably for amortization throughout this Note.

6. ROGER H. HERMANSON ET AL., ACCOUNTING PRINCIPLES 472 (4th ed. 1989).

7. See *infra* Part III.B.3.

business or that is held for the production of income.⁸ As a basic requirement for depreciation deductions, an asset must have an ascertainable life.⁹ Historically, goodwill has been deemed to have no limited legal life and a useful life that could not be reasonably estimated.¹⁰ As a result, goodwill was deemed nondepreciable for tax purposes as a matter of law.¹¹

In *Newark Morning Ledger*, the United States Supreme Court held that once an intangible asset is determined to have a useful life, it is subject to depreciation, regardless of its relationship to goodwill.¹² In light of the plain language of the applicable Treasury Regulation and case law, this result is logical and fair.

This Note offers an in-depth analysis of the decision reached in *Newark Morning Ledger*, presenting the relevant facts of the topic case, as well as the decisions reached by the lower courts. It analyzes the development of the law in the area of the depreciability of goodwill and provides a detailed explanation of the holding in the topic case, including the arguments presented, the issues resolved, and the views of the dissenting Justices. Finally, this Note discusses the implications of the Court's decision regarding business acquisitions and asset valuation.

II. FACT SECTION

In 1976, the Herald Company [hereinafter Herald], a newspaper publisher, purchased the outstanding shares of Booth Newspapers, Inc. [hereinafter

8. I.R.C. § 167(a) (1988). Obsolescence is a term used to refer to any normal, technological change in an asset resulting from reasonably foreseeable economic conditions. D. LARRY CRUMBLY ET AL., WEST'S FEDERAL TAXATION: INDIVIDUAL INCOME TAXES 9-2 to 9-3 (William H. Hoffman, Jr. et al. eds., 1992). In the event of abnormal or rapid obsolescence, a taxpayer may elect to use a shorter estimated useful life upon showing that there is a clear and convincing basis for the redetermination. *Id.* at 9-3.

The term depreciation can cause confusion in the area of taxation. Hollingsworth & Harrison, *supra* note 3, at 63. For example, one early definition of depreciation was "the decrease in exchangeable value of a wasting asset, computed on the basis of [the] cost expired in seeking profits during the period." Hollingsworth & Harrison, *supra* note 3, at 63-64 (citing PERCY D. LEAKE, DEPRECIATION AND WASTING ASSETS 9 (1976)). Any costs incurred to seek profits, of which both elements are key in this definition of depreciation, should be treated as expenses in the same period that any income related to those expenses is generated. Hollingsworth & Harrison, *supra* note 3, at 64.

On the other hand, compare a more recent definition of depreciation: "A decrease or loss in value because of wear, age, or other cause." THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 355 (William Morris ed., 1981). The focus of this definition is on the *value* of the asset, rather than the expiration of cost. To add to the confusion, neither of these definitions are aligned with the accounting and tax standpoint that depreciation is based on an individual asset's *cost*. Hollingsworth & Harrison, *supra* note 3, at 64.

9. See Treas. Reg. § 1.167(a)-3 (as amended in 1960).

10. HERMANSON, *supra* note 6, at 473.

11. See *infra* notes 46-53 and accompanying text. While historically not depreciated for tax purposes, goodwill has generally been depreciated over a period of 40 years for accounting purposes, creating a permanent difference between the income shown on a company's books and its taxable income. Hollingsworth & Harrison, *supra* note 3, at 51. In theory, goodwill must be depreciated for financial accounting purposes in order to avoid the overstatement of a business' net income, which can result if all expenses are not deducted from their related revenues. Walburn, *supra* note 3, at 473 (citing GEORGE R. CATLETT & NORMAN O. OLSON, ACCOUNTING FOR GOODWILL 80, Accounting Research Study No. 10 (American Inst. of Certified Pub. Accountants 1968)). "This requirement is necessary because the value of purchased goodwill will eventually disappear." HERMANSON, *supra* note 6, at 473. For all practical and theoretical purposes, this rationale should be recognized by the tax law as well. Walburn, *supra* note 3, at 474.

12. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1683 (1993).

Booth].¹³ Herald and Booth effected a merger in 1977, upon which Herald allocated its adjusted basis¹⁴ in the Booth shares among the acquired assets in proportion to their individual fair market values at the time of merger.¹⁵ Herald's adjusted basis in the Booth shares was approximately \$328 million and was allocated as follows: \$234 million to various financial and tangible assets; \$67.8 million to an intangible asset labeled "paid subscribers;" and \$26.2 million to going-concern value and goodwill.¹⁶

Paid subscribers consisted of 460,000 at-will customers who had requested regular delivery of the newspapers and who were expected to continue their subscriptions after the Herald acquisition.¹⁷ The value attributed to the paid subscribers was calculated using the "income approach."¹⁸ First, Herald used statistical experts to estimate the length of time an average subscriber would continue to subscribe.¹⁹ These useful life estimations were based on actuarial factors such as death and relocation.²⁰ Second, the experts determined the gross revenue stream that the subscriptions would generate over their estimated useful lives and calculated its present value.²¹ A net revenue stream of \$67.8 million from the paid subscribers asset was estimated by subtracting projected costs of collection from the present value of the determined gross revenue stream.²²

Herald then claimed depreciation deductions for the \$67.8 million asset on a straight-line basis on its income tax returns for the years 1977 through 1980.²³ The deductions were disallowed by the IRS because the paid subscribers concept

13. *Id.* at 1672. Booth published daily and Sunday newspapers in eight Michigan communities: *The Ann Arbor News*, *The Bay City Times*, *The Flint Journal*, *The Grand Rapids Press*, *The Jackson Citizen Patriot*, *Kalamazoo Gazette*, *The Muskegon Chronicle*, and *The Saginaw News*. *Id.* & n.2.

14. The adjusted basis of property is the property's original basis—typically its cost—increased by capital additions and decreased by recoveries of capital. CRUMBLY, *supra* note 8, at 14-3. Capital additions include the taxpayer's cost of capital improvements made to the property. CRUMBLY, *supra* note 8, at 14-3. Capital recoveries include depreciation allowances, investment tax credits, and losses resulting from casualty or theft. CRUMBLY, *supra* note 8, at 14-4.

15. *Newark Morning Ledger*, 113 S. Ct. at 1672. The tax code provisions in effect in 1977 required this type of allocation. *Id.* See 26 U.S.C. §§ 332, 334(b)(2) (1976).

Upon the purchase of a business, a buyer must allocate the purchase price first to tangible assets and certain specifically identifiable intangibles according to their relative fair market values. See I.R.C. § 1060 (1988); Temp. Treas. Reg. § 1.1060-1T(d) (1988). The remaining purchase price must be allocated to "intangible assets in the nature of goodwill and going concern value." Temp. Treas. Reg. § 1.1060-1T(d)(2)(iii) (1988). See also CRUMBLY, *supra* note 8, at 14-9.

16. *Newark Morning Ledger*, 113 S. Ct. at 1672-73.

17. *Id.* at 1672 n.4.

18. *Id.* at 1673. The income approach is commonly used because it best reflects the method a purchaser and seller would use to value intangible assets other than goodwill and going-concern value. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 182 (D.N.J. 1990), *rev'd*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993). The income approach measures the entire net stream of income to be generated by an intangible asset. *Newark Morning Ledger*, 945 F.2d at 562.

19. *Newark Morning Ledger*, 113 S. Ct. at 1673.

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.* Annual depreciation under the straight-line method is calculated as follows: asset cost, less estimated salvage value, divided by estimated years of useful life. HERMANSON, *supra* note 6, at 104.

was indistinguishable from goodwill and, as a result, nondepreciable under the applicable Treasury Regulation.²⁴ Herald paid the additional taxes assessed.²⁵

In 1987, Herald merged with Newark Morning Ledger Company [hereinafter Newark].²⁶ After the merger, Newark, as successor to Herald, filed a timely claim for refund of the additional taxes that were paid by Herald upon disallowance of the depreciation deductions.²⁷ After six months passed,²⁸ during which the IRS took no action on the claim, Newark brought suit in the United States District Court for the District of New Jersey to recover the additional taxes paid, plus interest.²⁹

Litigation ensued, and the Government's basic argument for disallowing the deductions was that the nature of paid subscribers was indistinguishable from goodwill.³⁰ Although it stipulated to the expert evidence presented by Newark regarding the estimated useful lives of the paid subscribers for each newspaper, the Government applied a "cost approach" in valuing the asset,³¹ submitting that the value would be equal to the "cost" of generating 460,000 subscriptions—the number of subscriptions represented by paid subscribers—through a subscription drive.³² Using this method, the Government estimated the cost of generating a commensurate number of subscriptions, and therefore the value of the asset, at approximately three million dollars.³³ The Government argued that the value of the asset would have to be recovered upon disposal of the business rather than

24. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1673 (1993). Treasury Regulation § 1.167(a)-3 states:

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.

Treas. Reg. § 1.167(a)-3 (as amended in 1960).

25. *Newark Morning Ledger*, 113 S. Ct. at 1673.

26. *Id.* at 1672.

27. *Id.* at 1673. "A claim for refund generally must be filed within *three years* from the date the return was filed or within *two years* from the date the tax was paid, whichever is later." CRUMBLEY, *supra* note 8, at 1-21.

28. A taxpayer cannot institute a suit against the IRS before six months has passed following a timely claim for refund. I.R.C. § 6532(a)(1) (1988).

29. *Newark Morning Ledger*, 113 S. Ct. at 1673. Once a taxpayer decides to pursue litigation, it has the choice of seeking a "refund" or "non-refund" route. Upon filing suit in a federal district court or the United States Claims Court, the taxpayer must pay the alleged taxes owed and sue for a refund—the refund route. CRUMBLEY, *supra* note 8, at 2-13. If the taxpayer wishes to sue immediately and pay the taxes if it loses its case, it can file suit in the United States Tax Court—the non-refund route. CRUMBLEY, *supra* note 8, at 2-13 to 2-14. However, the taxpayer must consider when filing in Tax Court that interest and penalties will run from the date the taxes are due until the tax is paid. CRUMBLEY, *supra* note 8, at 2-14.

30. *Newark Morning Ledger*, 113 S. Ct. at 1673.

31. *Id.* The cost approach measures the actual cost of generating a comparable asset. *Newark Morning Ledger Co. v. United States*, 945 F.2d 555, 562 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993).

32. *Newark Morning Ledger*, 113 S. Ct. at 1673.

33. *Id.*

currently deducted since goodwill was nondepreciable as a matter of law, and the paid subscribers asset was indistinguishable from goodwill.³⁴

The district court adopted a two-pronged test: In order to depreciate an intangible asset, a taxpayer must show that "the asset has] [(1)] a limited useful life, the duration of which can be estimated with reasonable accuracy, and [(2)] an ascertainable value separate and apart from goodwill."³⁵ In fact, the parties agreed that if the court determined that the paid subscribers asset had a useful life which could be estimated with reasonable accuracy and a value separate from goodwill, then Newark was entitled to depreciate the asset on a straight-line basis.³⁶

Influenced by the competent statistical evidence Newark presented demonstrating that a limited life could be estimated with reasonable accuracy, the court held it was self-evident that the asset had a limited useful life because by necessity the subscriptions would terminate upon the death of the subscribers.³⁷ It noted that by definition goodwill has an *indefinite* life, and since the paid subscribers had *limited* lives that were estimated with reasonable accuracy, they represented an asset with a value separate and apart from goodwill.³⁸ Therefore, as agreed upon by the parties, Newark was entitled to the deductions.³⁹

The decision reached by the district court was reversed by the Court of Appeals for the Third Circuit, which held that even if the asset had a limited useful life that could be ascertained with reasonable accuracy, the value of the asset was not separate and distinct from goodwill.⁴⁰ The court of appeals posited that the district court had used the wrong definition of goodwill.⁴¹ Instead, it adopted the definition that goodwill is the expectation that old customers will continue to do business with the company.⁴² As a result, the court of appeals determined that the paid subscribers asset was the epitome of goodwill.⁴³ Because there was a perceived conflict among various circuits regarding the depreciability of goodwill,⁴⁴ the United States Supreme Court granted certiorari to resolve this issue.⁴⁵

34. *Id.* The IRS posited that Newark should have to add the value of the goodwill to the basis, or cost, of the business so that upon disposal of the business the cost of goodwill would be deducted from the proceeds received on sale in computing capital gain or loss. *Id.* See *infra* note 259 and accompanying text.

35. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 184 (D.N.J. 1990), *rev'd*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993).

36. *Newark Morning Ledger*, 734 F. Supp. at 180. See *supra* note 23.

37. *Newark Morning Ledger*, 734 F. Supp. at 176, 180.

38. *Id.* at 182-83.

39. *Id.* at 180, 185.

40. *Newark Morning Ledger Co. v. United States*, 945 F.2d 555, 556, 568 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993).

41. *Newark Morning Ledger*, 945 F.2d at 568.

42. *Id.*

43. *Id.*

44. *Newark Morning Ledger*, 113 S. Ct. at 1674 & n.5. Compare *Newark Morning Ledger*, 945 F.2d at 555 (holding that a newspaper's paid subscribers asset is indistinguishable from goodwill and therefore nondepreciable as a matter of law) with *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987) (holding that a newspaper's paid subscribers asset is depreciable once it is found to have a reasonably-ascertainable life). See *supra* note 2 and accompanying text.

45. *Newark Morning Ledger*, 113 S. Ct. at 1674.

III. BACKGROUND AND HISTORY OF THE LAW

A. *The Internal Revenue Code*

The concept of allowing a deduction for depreciation of an asset has been explicitly recognized as a part of the federal tax system since 1909, when Congress authorized corporations to calculate net income by deducting, *inter alia*, a reasonable allowance for depreciation from gross income.⁴⁶ The Tariff of 1909 did not prohibit depreciation of *intangible* assets, but that position changed with the passage of the 1913 Income Tax Law.⁴⁷ Effective in 1914, Treasury Regulation 33 explicitly provided that depreciation was only applicable to the wear and tear of *physical* property, and not to assets that were not affected by use.⁴⁸ This prohibition excluded intangible assets from the depreciation allowance, except assets such as patents and copyrights.⁴⁹

The ban on depreciating intangible assets was short-lived. Under the Revenue Act of 1918, intangible assets were specifically recognized as being subject to the depreciation allowance.⁵⁰ However, it was later ruled that the plain language of the 1918 Act prohibited the depreciation of *goodwill* because goodwill could not represent an asset that was susceptible to exhaustion, wear, and tear, as was required for an asset to be qualified for depreciation under the Act.⁵¹ Since then, the Regulations that govern the depreciability of intangible assets have remained basically the same.⁵² The Regulation currently in force specifically exempts goodwill from depreciation, and the IRS has consistently taken the position that goodwill is non-depreciable *per se* since 1927.⁵³

46. *Id.* (citation omitted). See *supra* note 8 and accompanying text.

47. *Newark Morning Ledger*, 113 S. Ct. at 1674. An intangible asset lacks physical substance – e.g., goodwill, copyrights, patents – while a tangible asset has physical substance – e.g., equipment, buildings, etc. CRUMBLEY, *supra* note 8, at 9-2.

48. *Newark Morning Ledger*, 113 S. Ct. at 1674 n.7 (citation omitted).

49. *Id.*

50. *Id.* at 1674-75 (citations omitted).

51. *Id.* at 1675 n.8 (citing *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927)). The theory that goodwill has an unlimited life has been questioned. For example, one commentator has pointed out that at a given point in time, goodwill is much more a result of a business' recent activities rather than a continuation of goodwill that once existed at some time in the business' history. Walburn, *supra* note 3, at 468-69 (citing Walter C. Frank, *Goodwill Is Not Immortal: A Proposal to Deduct the Exhaustion of Purchased Goodwill*, 23 J. TAX'N 380, 381 (1965)). Absent continual efforts to create new goodwill, any goodwill a business once had will soon disappear. Walburn, *supra* note 3, at 469 (citing Frank, *supra*, at 381). There are an unlimited number of internal and external factors that can erode a business' ability to generate excess earnings (i.e. goodwill): changes in management, improvements in competitors' products, and changes in technology, to name a few. Walburn, *supra* note 3, at 469 (citing Frank, *supra*, at 380).

52. *Newark Morning Ledger*, 113 S. Ct. at 1675.

53. *Id.* See *supra* note 24.

B. The Meaning of Goodwill

1. The Definition of Goodwill

Goodwill has never been defined by the IRS, but since 1893 courts have attempted to articulate a workable definition.⁵⁴ Particularly, *Boe v. Commissioner* established a definition of goodwill commonly used by later courts.⁵⁵ In *Boe*, the taxpayer (Boe) and three of his associates acquired a medical practice upon purchasing the practice's assets, including goodwill, for a lump sum.⁵⁶ The practice was run by having patients sign a contract for medical services and requiring the patients to pay dues to the practice in advance.⁵⁷ In the normal course of business some of these medical contracts were terminated, and Boe deducted the cost of the terminated contracts as a business expense on his partnership tax return.⁵⁸

The IRS disallowed these deductions, classifying them as capital expenditures rather than deductible business expenses.⁵⁹ It argued that the amount paid for the medical practice, over the amount allocated to fixed assets and inventory, was goodwill, so that the cost would have to be recovered upon disposition of the business rather than currently deducted as a business expense.⁶⁰

The central issue in *Boe* was whether the excess purchase price for the medical practice, over and above the tangible assets, constituted goodwill or payment for individual medical contracts.⁶¹ Goodwill was defined as "the expectancy of continued patronage," and the court determined that the medical contracts were inseparable from goodwill since their value depended upon Boe and his associates'

54. *Newark Morning Ledger*, 113 S. Ct. at 1675. In 1893, the Supreme Court considered whether goodwill survived after a newspaper was purchased and ceased publication under its previous name. *Id.* In *Metropolitan National Bank v. St. Louis Dispatch Co.*, the *St. Louis Dispatch* and the *Evening Post* were consolidated into one newspaper called the *Post-Dispatch*. 149 U.S. 436, 437-39 (1893). Therefore, they ceased operating under their old names, and the Court ruled that the goodwill of the companies did not survive the name change. *Id.* at 447. The *Metropolitan* Court defined goodwill as the benefit obtained as a result of patronage by habitual customers. *Id.* at 446.

In *Des Moines Gas Co. v. City of Des Moines*, the plaintiff sought to enjoin the City of Des Moines from enforcing the provisions of a city ordinance fixing gas rates. 238 U.S. 153, 157 (1915). The Court determined that the value of goodwill should not be included in the valuation of a public service corporation for the purpose of fixing rates. *Id.* at 165. The Court defined goodwill as the value inherent in the customers' favorable impression of a well-known and well-conducted business. *Id.* at 164-65. This definition was reaffirmed in 1933 in *Los Angeles Gas & Electric Corp. v. Railroad Commission*, 289 U.S. 287 (1933).

55. 307 F.2d 339 (9th Cir. 1962). *See, e.g.*, *Colorado Nat'l Bankshares, Inc. v. Commissioner*, 984 F.2d 383 (10th Cir. 1993); *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); *Concord Control, Inc. v. Commissioner*, 615 F.2d 1153 (6th Cir. 1980); *AmSouth Bancorporation & Subsidiaries v. United States*, 681 F. Supp. 698 (N.D. Ala. 1988).

56. *Boe*, 307 F.2d at 340.

57. *Id.*

58. *Id.* The four owners subsequently split their interests and formed two partnerships, but continued to operate out of the same offices and use the same records. *Id.* at 341.

59. *Id.* at 342. The distinction between a capital expenditure and a business expense is that a business expense is currently deductible from income while a capital expenditure is added to the basis of the asset and recovered through annual depreciation. CRUMBLEY, *supra* note 8, at 6-23. When an expenditure is classified as capital in nature, an immediate tax benefit is lost, but the cost of the expenditure can be periodically deducted from income over a longer period of time. CRUMBLEY, *supra* note 8, at 6-23.

60. *Boe*, 307 F.2d at 342. *See supra* note 15 and accompanying text.

61. *Boe*, 307 F.2d at 342.

expectation that they would not be terminated.⁶² As a result, the distinction between the excess purchase price paid for goodwill or for medical contracts did not have to be made: Since the medical contracts were inseparable from goodwill and goodwill was not depreciable, the deductions were not allowed.⁶³

2. The Purpose of Depreciation

The purpose of tax depreciation from an economic point of view is to attempt to annually measure the decline in value of a taxpayer's depreciable asset resulting from that asset's use in the business for the production of income over the asset's useful life.⁶⁴

The Supreme Court addressed the purpose of depreciation in *Massey Motors, Inc. v. United States*.⁶⁵ *Massey Motors, Inc.* [hereinafter *Massey*] was a franchised Chrysler dealer.⁶⁶ *Massey* made certain assignments and rentals of its cars for specified periods of time, and later sold the cars after they had accumulated mileage to customers.⁶⁷ Gains on these customer sales were calculated by deducting *Massey's* cost basis in the cars, less depreciation taken on the cars, from the sale price, and applying capital gain rates to the determined net gain.⁶⁸ For purposes of depreciation, *Massey* used the total economic life of the cars for the useful life and the junk value as salvage value.⁶⁹

The IRS argued that the useful life was only the actual period when the automobile was used in the business by the taxpayer rather than its total economic life.⁷⁰ It was also argued that the salvage value was the resale value at the time *Massey* disposed of the asset rather than its junk value.⁷¹ As a result of the variations in the valuations, the IRS disallowed the depreciation deductions.⁷²

The Supreme Court held that the IRS' position was more in line with Congress' intent in allowing depreciation.⁷³ The primary purpose of depreciation is

62. *Id.* at 343.

63. *Id.*

64. Walburn, *supra* note 3, at 458 (citing MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS ¶ 6.08, at 142 (6th ed. 1991)).

65. 364 U.S. 92 (1960). This opinion was a consolidation of two cases: *Massey Motors* and *Commissioner v. Evans*. *Id.* at 93.

66. *Id.* at 95.

67. *Id.* *Massey* assigned some of its cars to company personnel, selling the cars after 8000 to 10,000 miles of use, and rented some cars to unaffiliated finance companies, selling them after approximately 40,000 miles of use. *Id.*

68. *Id.* at 95-96. Upon the sale of property, gain is generally calculated by deducting the acquisition cost of the asset, reduced by any depreciation taken on the asset, from the selling price of the asset. CRUMBLEY, *supra* note 8, at 3-28. When the asset is capital in nature (see I.R.C. § 1221 (1988)), capital rates are applied to the gain rather than ordinary rates. CRUMBLEY, *supra* note 8, at 3-29. For a general discussion of the distinctions between capital and ordinary gains, see CRUMBLEY, *supra* note 8, at 3-28 to 3-32.

69. *Massey Motors*, 364 U.S. at 94-95. For an explanation of the straight-line method of depreciation, see *supra* note 23.

70. *Massey Motors*, 364 U.S. at 94.

71. *Id.*

72. *Id.*

73. *Id.* at 106-07. Congress intended that the allowance for depreciation enable the taxpayer to "recover only the cost of the asset less the estimated salvage, resale or second-hand value." *Id.* at 107.

allocating the cost of using an asset to the time period to which it contributes, thereby providing reliable periodic income statements.⁷⁴ By requiring that an asset's useful life be related to the period in which the taxpayer reasonably expects to use the asset in its business, the Court noted that the IRS' approach was more likely to correctly reflect the actual cost of the asset during the periods the asset was used in the business.⁷⁵

This principle was recently reiterated in *Indopco, Inc. v. Commissioner*.⁷⁶ In *Indopco*, National Starch & Chemical Corporation [hereinafter National Starch] and Unilever United States, Inc. [hereinafter Unilever] wanted to effectuate a tax-free transaction under Delaware law whereby Unilever would buy out National Starch.⁷⁷ They accomplished their plan pursuant to an IRS private ruling which declared that the transaction would be tax-free, in regard to which the two companies incurred substantial fees.⁷⁸ National Starch claimed a deduction for these expenses, but it was disallowed by the IRS because the expenses were considered capital expenses and therefore not deductible as business expenses.⁷⁹

The Court pointed out that the IRS allows current deductions of business expenses in order to correctly match revenue and expenses to their applicable taxable period.⁸⁰ For tax purposes, these deductions will result in an accurate calculation of the period's net income.⁸¹ On the other hand, capital expenditures are generally added to an asset's basis and recovered through depreciation deductions over the asset's useful life.⁸² The fees incurred by National Starch were ultimately held to be capital expenditures and therefore not currently deductible as a business expense.⁸³

3. The Depreciability of Goodwill

It was first established in *Red Wing Malting Co. v. Willcuts* that goodwill was not depreciable.⁸⁴ Red Wing Malting Company [hereinafter Red Wing] manufactured and sold barley malt,⁸⁵ and as a result of Prohibition, its business was

74. *Id.* at 104. See *supra* note 11.

75. *Massey Motors, Inc. v. United States*, 364 U.S. 92, 106 (1960).

76. 112 S. Ct. 1039 (1992). The Court further discussed the underlying distinctions between ordinary and necessary business expenses and capital expenditures. *Id.* See *supra* note 59. The fees incurred by National Starch were ultimately found to be capital expenditures and therefore not capable of a current deduction as a business expense. *Indopco*, 112 S. Ct. at 1046.

77. *Indopco*, 112 S. Ct. at 1041.

78. *Id.* at 1041-42. Letter rulings are issued by the IRS upon a taxpayer's request as to how the IRS will treat a proposed transaction for tax purposes. CRUMBLEY, *supra* note 8, at 2-9. Letter rulings are limited to certain pre-announced areas of taxation and are only binding on the IRS with respect to the individual taxpayer that sought the ruling. CRUMBLEY, *supra* note 8, at 2-9.

79. *Indopco*, 112 S. Ct. at 1042. See *supra* note 59.

80. *Indopco*, 112 S. Ct. at 1043.

81. *Id.*

82. *Id.* at 1042. See CRUMBLEY, *supra* note 8, at 6-22 to 6-23.

83. *Indopco*, 112 S. Ct. at 1046.

84. 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927).

85. *Red Wing Malting*, 15 F.2d at 627. Barley malt is used in the brewing and distilling of alcoholic beverages. THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 791 (William Morris ed., 1981).

destroyed.⁸⁶ Prior to its destruction, Red Wing had goodwill of approximately \$153,600, which became worthless after Prohibition.⁸⁷ Red Wing then sold its manufacturing operations.⁸⁸ The disputed issue in this case was whether Red Wing was entitled to a business deduction for the loss of its goodwill.⁸⁹

Red Wing argued that it was entitled to a deduction under section 234(a)(7) of the Revenue Act of 1918.⁹⁰ That section provided for “[a] reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.”⁹¹

Litigation focused on whether the appended phrase of the section providing for obsolescence created a new, separate basis for a depreciation deduction, or whether it was only an extension of the previous phrase.⁹² The court held for the latter proposition, concluding that since goodwill is not exhausted by the operation of business and therefore does not become obsolete, depreciation cannot be charged against it.⁹³ Ultimately, the court held that Congress had not intended for goodwill to be dealt with separately from the business to which it is attached, so that Red Wing could not take a deduction for a loss of goodwill separate from its business.⁹⁴ The IRS has taken this position since 1927, the year following the *Red Wing* decision.⁹⁵

C. The Mass-Asset Rule

The mass-asset rule is used by courts to preclude depreciation of customer-based intangible assets because in theory they are self-regenerating assets that may change over time, but never diminish in value.⁹⁶ *Golden State Towel & Linen Service, Ltd. v. United States* set forth the generally accepted definition of a mass asset:

[A] purchased terminable-at-will type of customer list is an indivisible business property with an indefinite, nondepreciable life, indistinguishable from—and the principal element of—goodwill, whose ultimate value lies in the expectancy of continued patronage through public acceptance. It is subject to temporary attrition as well as expansion through departure of some customers, acquisition of others, and increase or decrease in the requirements of individual customers. A normal turnover of customers represents merely the ebb and flow of a continuing property status in this species, and does not within ordinary limits give rise to the right to deduct for

86. *Red Wing Malting*, 15 F.2d at 627. Prohibition forbade the manufacture, sale, and transportation of alcoholic liquors for beverage purposes. WEBSTER'S NEW WORLD DICTIONARY 1136 (2d college ed. 1982).

87. *Red Wing Malting*, 15 F.2d at 627.

88. *Id.*

89. *Id.* at 627-28.

90. *Id.* at 628.

91. Revenue Act of 1918, 40 Stat. 1057, 1078 (1918) (current version at I.R.C. § 167(a) (1988)).

92. *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626, 628 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927). See *supra* note 8.

93. *Red Wing Malting*, 15 F.2d at 629, 631, 633. See *supra* note 51.

94. *Red Wing Malting*, 15 F.2d at 633-34.

95. See *supra* notes 46-53 and accompanying text.

96. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1676 (1993).

tax purposes the loss of individual customers. The whole is equal to the sum of its fluctuating parts at any given time, but each individual part enjoys no separate capital standing independent of the whole, for its disappearance affects but does not interrupt or destroy the continued existence of the whole.⁹⁷

Golden State Towel & Linen Service, Ltd. [hereinafter Golden State] acquired two of its competitors and allocated a portion of the purchase price to customer lists.⁹⁸ It capitalized these lists and sought to deduct a loss for the cost of acquiring a customer when that customer ceased doing business with it.⁹⁹ The issue to be decided was whether a customer list would be considered an indivisible asset for tax purposes.¹⁰⁰

The court held that terminable-at-will customer lists are indistinguishable from goodwill, representing an indivisible business property in which customer turnover is only indicative of the ebb and flow of property that is continuous in nature.¹⁰¹ Further, the individual parts (each customer) of the whole asset (the customer list) have no separate capital standing because the extinguishment of one customer does not extinguish the continuity of the whole customer list.¹⁰² Therefore, Golden State was not allowed to deduct a separate loss when individual customers ceased doing business with it.¹⁰³

The Fifth Circuit handed down a decision of great import in *Houston Chronicle Publishing Co. v. United States*, in which it held that the mass-asset rule did not create a per se rule of nondepreciability simply because an intangible asset is related to goodwill.¹⁰⁴ *Houston Chronicle Publishing Company* [hereinafter *Houston Chronicle*] acquired the assets of the *Houston Press Company*, which included subscription lists, inter alia.¹⁰⁵ The lists were valued at \$71,200 by taking *The Houston Press'* approximate circulation of 89,000 newspapers and multiplying that number by forty percent to reach a certain number of people estimated to become subscribers to *The Houston Chronicle*.¹⁰⁶ This number (35,600) of estimated subscribers was multiplied by the average cost of obtaining new subscribers (two dollars).¹⁰⁷ *Houston Chronicle* did not intend to continue publication of *The Houston Press*, so the customer list was not considered a self-regenerating asset for purposes of the mass-asset rule.¹⁰⁸ The asset was only valuable to the extent that it

97. 373 F.2d 938, 944 (Ct. Cl. 1967).

98. *Id.* at 939.

99. *Id.* See *supra* note 34.

100. *Golden State*, 373 F.2d at 939.

101. *Id.* at 944.

102. *Id.*

103. *Id.*

104. 481 F.2d 1240, 1249-50 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). The court also ruled on the tax treatment of lease acquisition costs and the deductibility of abandonment and demolition losses. *Houston Chronicle*, 481 F.2d at 1254, 1261.

105. *Houston Chronicle*, 481 F.2d at 1243.

106. *Id.* at 1243-44.

107. *Id.* at 1244. These figures were not disputed. *Id.*

108. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1677 (1993).

furnished the names and addresses of prospective subscribers to *The Houston Chronicle*.¹⁰⁹

Houston Chronicle estimated the asset's useful life to be five years and claimed one-fifth of \$71,200—its estimated value—as depreciation each year.¹¹⁰ Arguing that the subscriptions were in essence goodwill, so that the asset was nondepreciable as a matter of law, the IRS disallowed the deductions.¹¹¹ Houston Chronicle argued that it could depreciate the asset under § 167(a) of the Code if it could show the asset had a limited useful life, of which the duration could be ascertained.¹¹² Conversely, the IRS argued that even if such lists were sometimes capable of depreciation, Houston Chronicle had not provided sufficient evidence of a useful life for an allowance of depreciation deductions.¹¹³ The IRS further argued that in any event, the mass-asset rule applied to bar depreciation of the customer-based asset.¹¹⁴

The court opined that most courts applying the mass-asset rule are dealing with a taxpayer that fails to meet its evidentiary burden.¹¹⁵ Thus, the mass-asset rule did not establish nondepreciability per se and did not prohibit depreciation if the taxpayer sufficiently met its factual burden of proving the asset had a value distinct from goodwill and a limited life that could be ascertained with reasonable accuracy.¹¹⁶

Furthermore, determining whether an intangible asset is indistinct from goodwill was a factual question turning on whether sufficient, competent evidence had proven the limited and ascertainable life of the asset.¹¹⁷ Goodwill was viewed as an asset that may fluctuate over time but did not diminish.¹¹⁸ The court ultimately held that

newspaper subscription lists such as those before [it] [were] intangible capital assets that may be depreciated for tax purposes if [the] taxpayer sustains [its] burden of proving that the lists (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy.¹¹⁹

In response to the Fifth Circuit's decision, the IRS issued a new ruling to the effect that customer-based intangible assets were not indistinguishable from

109. *Id.*

110. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1244 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

111. *Houston Chronicle*, 481 F.2d at 1244. *See supra* notes 46-53 and accompanying text.

112. *Houston Chronicle*, 481 F.2d at 1244. *See infra* note 193 and accompanying text.

113. *Houston Chronicle*, 481 F.2d at 1244.

114. *Id.* at 1249.

115. *Id.*

116. *Id.* at 1249-50.

117. *Id.* at 1249.

118. *Id.* at 1248.

119. *Id.* at 1251.

goodwill as a matter of law.¹²⁰ Although the IRS still took the position that these assets were generally in the nature of goodwill, it recognized that where these assets were susceptible of valuation, they could possibly be depreciated over their useful lives.¹²¹

The allowance of depreciation deductions for customer-based intangible assets in light of the mass-asset rule has primarily been a question of fact.¹²² For example, in *Richard S. Miller & Sons, Inc. v. United States*, Richard S. Miller & Sons, Inc. [hereinafter Miller] purchased insurance expirations from another insurer.¹²³ Depreciation deductions for the insurance expirations were disallowed by the IRS.¹²⁴ The court held that the expirations constituted a mass asset, of which the useful life related to the whole asset rather than its individual components.¹²⁵ It ruled that depreciation deductions were not prohibited by the mass-asset rule if the individual components could be valued separately and it could be shown that the whole asset had a limited useful life.¹²⁶

The value of the insurance expirations rested in their renewability, which allowed Miller to estimate a useful life for the purchased asset.¹²⁷ As a result, the costs associated with collection of the insurance expirations could be depreciated.¹²⁸

In *Citizens & Southern Corp. v. Commissioner*, the Tax Court held that the core deposit base of a bank could be depreciated.¹²⁹ Citizens & Southern Corporation [hereinafter Citizens] purchased nine separate banks, which included the core deposits of each bank.¹³⁰ It sought to depreciate the bank-deposit base acquired in this purchase.¹³¹ Citizens valued the deposit base in accordance with Generally Accepted Accounting Principles and estimated a useful life through lifing

120. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1677 (1993) (citing Rev. Rul. 74-456, 1974-2 C.B. 65, 66).

121. *Id.*

122. *Id.* at 1678.

123. 537 F.2d 446, 449 (Ct. Cl. 1976). Insurance expirations are procured as follows: When an insurance policy is issued, a copy of the face of the policy is made showing the name of the insured, the premium, the covered property, the type of insurance, and the expiration date. *Newark Morning Ledger*, 113 S. Ct. at 1678 n.10. This information allows insurance agents to contact clients when they are in need of new coverage. Pissott, *supra* note 3, at 1031 n.2. See Rev. Rul. 74-456, 1974-2 C.B. 65.

124. *Miller*, 537 F.2d at 449.

125. *Id.* at 450.

126. *Id.* at 452.

127. *Id.* at 454-55.

128. *Id.* at 457.

129. 91 T.C. 463 (1988), *aff'd per curiam*, 919 F.2d 1492 (11th Cir. 1990). The depreciability of the core deposit base of financial institutions has been the subject of a great deal of commentary. See, e.g., *Bank's Accelerated Depreciation of Core Deposits Upheld*, 74 J. TAX'N 44 (1991); Hollingsworth & Harrison, *supra* note 3; Haahr, *supra* note 3; Catherine A. Tanck, Comment, *Depreciation of the Core Deposit Intangible: A Tax Incentive to Acquire a Failed Bank*, 32 S.D. L. Rev. 80 (1987).

130. *Citizens & S.*, 91 T.C. at 466, 514.

131. *Id.* at 478. Deposit base is an intangible asset which represents the present value of future income expected from using purchased core deposits. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1678 n.11 (1993).

studies.¹³² These studies showed that over a period of time a certain percentage of the purchased banks' accounts would be closed.¹³³

The Commissioner argued that the purchased core deposits were indistinguishable from goodwill.¹³⁴ However, the court held that Citizens could depreciate the asset because it had established a value and estimated useful life for the deposit base.¹³⁵ Although as old accounts closed new accounts would be opened, the purchased deposit base was not considered self-regenerating.¹³⁶

The Tax Court continues to use the mass-asset rule as a guide.¹³⁷ In 1991, it faced the question of whether the value of a trained work force could be depreciated in *Ithaca Industries, Inc. v. Commissioner*.¹³⁸ Ithaca Industries, Inc. [hereinafter Old Ithaca] manufactured intimate apparel.¹³⁹ To effectuate a leveraged buyout, New Ithaca Corporation [hereinafter New Ithaca] was formed.¹⁴⁰ New Ithaca bought the stock of Old Ithaca, and Old Ithaca was liquidated.¹⁴¹ New Ithaca then changed its name to Ithaca Industries, Inc. [hereinafter Ithaca].¹⁴² Ithaca attempted to depreciate the value of the trained work force it had acquired in the merger over the period of time each employee would remain with the new company.¹⁴³

The court prohibited the deductions via the mass-asset rule.¹⁴⁴ It reasoned that since Ithaca hired new employees to replace those who left the company, the work force would not diminish over time or as a result of its use.¹⁴⁵ Therefore, when an employee left, the continued existence of the whole asset was not destroyed because a new employee was hired to keep the work force unchanged.¹⁴⁶

In *Colorado National Bankshares, Inc. v. Commissioner*, Colorado National Bankshares, Inc. [hereinafter Colorado National] bought seven banks and sought to depreciate the difference in value between the interest paid on the core deposits of those banks and the rate of interest at which Colorado National was going to

132. *Citizens & S.*, 91 T.C. at 467-78. To establish standards for businesses to use in recording the economic effects of their transactions and in reporting these effects to outside parties, the accounting profession issues authoritative pronouncements in the form of Generally Accepted Accounting Principles, otherwise known as "GAAP." Walburn, *supra* note 3, at 472 n.93.

133. *Citizens & S.*, 91 T.C. at 467-78.

134. *Id.* at 480.

135. *Id.* at 479, 514.

136. *Id.* at 499.

137. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1677 (1993).

138. 97 T.C. 253 (1991), *aff'd*, 17 F.3d 684 (4th Cir. 1994).

139. *Ithaca Indus.*, 97 T.C. at 255.

140. *Id.* at 255-56.

141. *Id.* at 256.

142. *Id.*

143. *Id.* at 261.

144. *Id.* at 267-68, 272.

145. *Id.*

146. *Id.*

reinvest those core deposits.¹⁴⁷ The IRS classified these core deposits as part of the acquired goodwill and disallowed the deductions.¹⁴⁸

The Tax Court noted that core deposits are valued upon the probability that customers will leave their money on deposit for certain periods of time, not for an uncertain span of time in the future.¹⁴⁹ Since Colorado National was able to present an accurate prediction of a useful life for the core deposits, the court held them separate from goodwill and capable of valuation for depreciation deductions.¹⁵⁰

D. Donrey, Inc. v. United States

The Eighth Circuit considered the question of whether subscription lists purchased by a newspaper are depreciable in *Donrey, Inc. v. United States*.¹⁵¹ Upon purchasing the *Washington Times Herald*, Donrey, Inc. [hereinafter Donrey] depreciated the portion of the purchase price that was allocable to subscription lists, and the IRS disallowed the deduction.¹⁵² While the IRS argued that the list was a part of goodwill, a jury found that the asset was distinct from goodwill, and that Donrey had reasonably ascertained its limited life.¹⁵³ The court followed the test given in *Houston Chronicle, supra*, and held the asset was depreciable because the jury found it had a reasonably-ascertained useful life.¹⁵⁴

In agreement with the IRS, the dissent in Donrey argued that this asset represented goodwill.¹⁵⁵ It further distinguished *Houston Chronicle*, reasoning that *Houston Chronicle* planned to discontinue the publication of the paper it purchased.¹⁵⁶ Goodwill is thought to be acquired where the "transfer enables the purchaser to step into the shoes of the seller."¹⁵⁷ The dissent argued that in this case Donrey just stepped into the shoes of the *Washington Times Herald* and, as such, the asset represented goodwill.¹⁵⁸

IV. INSTANT CASE

Newark Morning Ledger Co. v. United States answers the question of whether the IRS can treat intangible assets as nondepreciable strictly because they are considered goodwill, even after they are proven to have a reasonably-ascertained,

147. 984 F.2d 383, 384 (10th Cir. 1993).

148. *Id.*

149. *Colorado Nat'l Bankshares, Inc. v. Commissioner*, 60 T.C.M. (CCH) 771, 789 (1990), *aff'd*, 984 F.2d 383 (10th Cir. 1993).

150. *Colorado Nat'l*, 984 F.2d at 387.

151. 809 F.2d 534, 535 (8th Cir. 1987).

152. *Id.* at 535. *See supra* note 15.

153. *Donrey*, 809 F.2d at 536.

154. *Id.* at 537.

155. *Id.* at 539 (Bright, J., dissenting).

156. *Id.* at 538.

157. *Id.*

158. *Id.* at 538-39.

limited useful life.¹⁵⁹ Justice Blackmun delivered the majority opinion, in which Justices Stevens, O'Connor, Kennedy, and Thomas joined.¹⁶⁰

A threshold question before the Court was whether Newark had used the correct approach in valuing the paid subscribers asset.¹⁶¹ Newark used the income approach to value the asset based on its net revenue stream.¹⁶² While the Government argued that the appropriate method of valuation was the cost approach, it offered no evidence challenging the accuracy of the income approach used by Newark.¹⁶³ Ultimately, the Supreme Court accepted Newark's approach and rejected the cost approach.¹⁶⁴

The Government had argued that the only way to appropriately value the asset was to determine the cost of generating a list of new subscribers.¹⁶⁵ However, the Court pointed out that the Government had mischaracterized the asset.¹⁶⁶ The evidence presented at trial proved that the paid subscribers provided a periodic, predictable source of income over a certain period of time and did not represent just a list of names and addresses.¹⁶⁷ Valuing the asset based on the generation costs of a list of *new* subscribers would be futile because that value would represent an entirely different asset.¹⁶⁸

In response, the Government argued that the income approach only measures an entire revenue stream without reductions for the corresponding expenses, rather than the net income associated with the asset.¹⁶⁹ The only costs Newark subtracted from the revenue stream were delivery and collection costs.¹⁷⁰ Additional costs, like production costs, were never considered.¹⁷¹ However, the Government offered no competent evidence to refute Newark's evidence of valuation.¹⁷²

Newark relied on a two-pronged test to depreciate an intangible asset under § 167 of the Code.¹⁷³ The first prong dealt with the intangible asset having a reasonably-ascertained, limited useful life.¹⁷⁴ At the district court level, the Government stipulated that if the district court found that the asset had a useful life that could be estimated with reasonable accuracy, then the asset could be depreciated

159. 113 S. Ct. 1670, 1672 (1993).

160. *Id.* at 1671.

161. *Id.* at 1682.

162. *Id.* at 1673. *See supra* note 18.

163. *Newark Morning Ledger*, 113 S. Ct. at 1673. *See supra* note 31.

164. *Newark Morning Ledger*, 113 S. Ct. at 1682-83.

165. *Id.* at 1682.

166. *Id.*

167. *Id.*

168. *Id.*

169. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 182 (D.N.J. 1990), *rev'd*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993).

170. *Newark Morning Ledger*, 734 F. Supp. at 182.

171. *Id.*

172. *Id.*

173. *Id.* at 184. *See infra* note 193.

174. *Newark Morning Ledger*, 734 F. Supp. at 184.

over its applicable useful life.¹⁷⁵ The Supreme Court recognized that this stipulation made Newark's burden of proof significantly lighter because Newark would not have to prove the specific useful life of the paid subscribers or that they were correctly estimated.¹⁷⁶ Instead, the expert testimony need only establish that the useful life of the asset *could* be estimated with reasonable accuracy.¹⁷⁷

The second prong of the test, and another aspect of the Government's stipulation, was that the court would have to determine that the asset had a value separate and distinct from goodwill.¹⁷⁸ The Government argued that the paid subscribers were indistinguishable from goodwill, and, therefore, nondepreciable, but conceded that goodwill characteristically has no determinate useful life.¹⁷⁹ Goodwill has also been described as nondepreciable *because* it has no useful life that can be reasonably ascertained.¹⁸⁰ The Court reasoned that if a taxpayer could prove that an asset's value wastes over a certain period of time with reasonable accuracy, then the asset would be depreciable under § 167 of the Code regardless of whether it was related to goodwill.¹⁸¹

The Supreme Court pointed out that the purpose of the Code in allowing deductions for depreciation is to match revenues with their corresponding expenses in order to more accurately calculate net income for tax purposes.¹⁸² Since the paid subscribers waste over an ascertainable period of time, the Court held that allowing the depreciation deduction would be more faithful to the purposes of the Code.¹⁸³

The relevant question for purposes of depreciation was whether the asset was capable of valuation and whether its value would diminish over time, not whether the asset represented goodwill.¹⁸⁴ Furthermore, the Court pointed out that the IRS itself had articulated this principle as follows: "Whether or not an intangible asset, or a tangible asset, is depreciable for Federal income tax purposes depends upon the determination that the asset is actually exhausting, and that such exhaustion is susceptible of measurement."¹⁸⁵

Newark argued further that the mass-asset rule did not apply to bar depreciation because the paid subscribers asset was not self-regenerating.¹⁸⁶ Earlier in the litigation, the court of appeals had suggested that the mass-asset rule was

175. *Id.* at 180.

176. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1681 (1993) (quoting *Newark Morning Ledger*, 734 F. Supp. at 181).

177. *Id.*

178. *Newark Morning Ledger*, 734 F. Supp. at 180.

179. *Newark Morning Ledger*, 113 S. Ct. at 1673, 1680.

180. 5 JACOB MERTENS, JR., *THE LAW OF FEDERAL INCOME TAXATION* § 23A.01, at 7 (Weinstein et al. eds., 1990). See *supra* note 51.

181. *Newark Morning Ledger*, 113 S. Ct. at 1680-81.

182. *Id.* at 1680 (quoting *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039, 1043 (1992)). See *supra* notes 64-83 and accompanying text.

183. *Newark Morning Ledger*, 113 S. Ct. at 1680.

184. *Id.* at 1681.

185. *Id.* (quoting Rev. Rul. 68-483, 1968-2 C.B. 91-92).

186. *Id.*

outdated,¹⁸⁷ but the Supreme Court pointed out that the Tax Court continues to apply the rule in cases involving certain intangible assets.¹⁸⁸

For purposes of the mass-asset rule, the Court supported the reasoning of the district court that since there was no automatic replacement for a cancelled subscription, the asset was not self-regenerating.¹⁸⁹ Even though the number of total subscribers may have stayed relatively the same, the asset did not consist of constantly fluctuating components.¹⁹⁰ Replacements for the cancelled subscriptions could have only been gained through the substantial efforts of Newark.¹⁹¹ Therefore, the mass-asset rule did not apply to prohibit the depreciation of the paid subscribers asset.¹⁹²

The Supreme Court ultimately reversed the decision of the court of appeals and held that Newark had sufficiently proven that the paid subscribers asset possessed the attributes necessary to qualify for a depreciation deduction under § 167 of the Code, regardless of whether the asset represented goodwill.¹⁹³

Justice Souter filed a dissenting opinion, in which Chief Justice Rehnquist and Justices White and Scalia joined.¹⁹⁴ Justice Souter argued that the paid subscribers represented an unmistakable measurement of goodwill, and the asset was therefore nondepreciable as a matter of law.¹⁹⁵ Furthermore, the dissenters believed that Newark's experts failed to show that the goodwill had a definite lifespan.¹⁹⁶

The dissent pointed out that the Treasury Regulation in question is more than sixty-five years old and has been reenacted without substantial change only six times since 1919.¹⁹⁷ Judicial interpretations of the Regulation have resulted in a general definition that goodwill is the expectation that customers will continue their patronage.¹⁹⁸ Further, Congress is presumed to have accepted the treatment of goodwill set out in the Regulation, as clarified through subsequent judicial decisions, because of the essentially unaltered language of the Regulation over the last

187. Newark Morning Ledger Co. v. United States, 945 F.2d 555, 561 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993).

188. Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670, 1677 (1993).

189. *Id.* at 1681 (quoting Newark Morning Ledger Co. v. United States, 734 F. Supp. 176, 180 (D.N.J. 1990), *rev'd*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993)).

190. *Id.*

191. *Id.*

192. *Id.* at 1683.

193. *Id.* Section 167(a) of the Code states:

(a) General rule

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.

I.R.C. § 167(a) (1988).

194. Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670, 1671-72 (1993).

195. *Id.* at 1684 (Souter, J., dissenting).

196. *Id.* at 1683.

197. *Id.* at 1685. See *supra* notes 46-53 and accompanying text.

198. Newark Morning Ledger, 113 S. Ct. at 1684 (Souter, J., dissenting). See *supra* notes 54-63 and accompanying text.

sixty-five years.¹⁹⁹ Justice Souter accused the majority of invading the political domain by attempting to rewrite a Treasury Regulation.²⁰⁰

The dissent found Newark's interpretation of goodwill—as being a residual asset equal to any portion of the purchase price of a business that does not correspond to assets with determinate lives—troubling.²⁰¹ Justice Souter stated that Newark's definition of goodwill, as accepted by the majority, was a blatant rejection of Congress' long-standing interpretation of a statute.²⁰²

The dissent noted that once it was clear that the paid subscribers asset came under the accepted judicial definition of goodwill, it was evident that the depreciation of the asset was barred by the express language of the Regulation.²⁰³ The plain language of that Regulation has been uniformly applied to prohibit depreciation of goodwill as a matter of law.²⁰⁴

In light of Newark's position on the depreciability of goodwill, the dissent secondarily presented an argument concerning Newark's expert evidence: Newark's expert failed to show the asset had a definite duration, as required for the depreciation of an intangible asset under § 167(a) of the Code.²⁰⁵

The dissent argued that Newark claimed to be entitled to depreciation of a *purchased* asset and not an asset attributable to efforts made after the purchase date.²⁰⁶ Justice Souter reasoned that Newark's expert based his opinion on the presumption that the total number of subscriptions would remain constant over time.²⁰⁷ This assumption supposed that the newspaper would remain attractive to the subscribers through Newark's efforts in running the newspaper business, in effect predicting the estimated life of the purchased asset combined with customer satisfaction through Newark's post-sale efforts.²⁰⁸ Newark's expert did not show when the purchased asset's separate value—as compared to the post-sale continuation of customer satisfaction—would deteriorate.²⁰⁹ Consequently, the dissent contended that Newark failed to prove the duration of the date-of-sale asset, but instead proved the periods over which the subscribers existing on the date of sale would continue to subscribe.²¹⁰

199. *Newark Morning Ledger*, 113 S. Ct. at 1685 (Souter, J., dissenting).

200. *Id.*

201. *Id.* at 1684-85. See *supra* note 15.

202. *Newark Morning Ledger*, 113 S. Ct. at 1684-85 (Souter, J., dissenting).

203. *Id.* at 1684. See *supra* note 24.

204. *Newark Morning Ledger*, 113 S. Ct. at 1684 (Souter, J., dissenting). See *supra* notes 84-95 and accompanying text.

205. *Newark Morning Ledger*, 113 S. Ct. at 1686, 1688-89 (Souter, J., dissenting). See *supra* note 193.

206. *Newark Morning Ledger*, 113 S. Ct. at 1686 (Souter, J., dissenting).

207. *Id.* at 1687.

208. *Id.* at 1687-88.

209. *Id.* at 1688.

210. *Id.* at 1688-89.

V. ANALYSIS

A. *Development of the Law*

1. The Depreciability of Goodwill

Since 1927, the IRS has taken the position that goodwill is nondepreciable as a matter of law.²¹¹ In direct contrast, the majority in *Newark Morning Ledger* reasoned that once an asset has been proven with reasonable accuracy to have a value that wastes over a certain period of time, that asset is subject to depreciation under § 167 of the Code whether or not it is related to goodwill.²¹²

Looking at the plain language of Treasury Regulation § 1.167(a)-3, this reasoning appears logical. The Regulation clarifies the allowance for depreciation of intangible assets by pointing out that while intangible assets with limited lives – of which the length can be reasonably estimated – may be subject to depreciation, an intangible asset without a limited life is *not* subject to depreciation.²¹³ The Regulation goes further to state that “[n]o deduction for depreciation is allowable with respect to goodwill.”²¹⁴ It therefore follows that goodwill is an intangible asset without a limited life, and the specific bar of depreciation for goodwill seems only to provide an example of such an asset.²¹⁵ However, intangible assets with a reasonably-ascertained useful life are subject to depreciation under the Regulation.²¹⁶

The majority in *Newark Morning Ledger* found that the intangible asset paid subscribers had a limited useful life that was reasonably estimated.²¹⁷ Although this asset was related to goodwill, it was not goodwill by definition because it had a reasonably-estimated limited useful life.²¹⁸ Therefore, it was not barred by the per se nondepreciability of goodwill.²¹⁹

The plain language of the Regulation provides the fatal flaw. While providing for the depreciation of intangible assets with limited lives and the specific exclusion of goodwill, the Regulation ignores the myriad of intangible assets that are so similar to goodwill that they are described as indistinguishable from it.²²⁰ The lack of a forthright rule addressing this particular issue has led to endless litigation in this area.²²¹ As a result, the plain language of the Regulation itself has forged a radical departure from the traditional treatment of goodwill.²²²

211. *Id.* at 1675 (Blackmun, J.). See *supra* notes 46-53 and accompanying text.

212. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1680-81 (1993).

213. Treas. Reg. § 1.167(a)-3 (as amended in 1960). See *supra* note 24.

214. Treas. Reg. § 1.167(a)-3 (as amended in 1960).

215. See *supra* note 51.

216. Treas. Reg. § 1.167(a)-3 (as amended in 1960).

217. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1683 (1993).

218. *Id.* at 1680 n.13.

219. *Id.*

220. See *supra* note 3 and accompanying text.

221. See *supra* Part III.B.3-D; see also *supra* note 2 and accompanying text.

222. See discussion *infra* Parts V.B-VI.

Theoretically, this departure finally engenders consistent treatment of purchasers of tangible assets and purchasers of intangible assets.²²³ While intangible assets do not possess the same inherent wasting characteristic as tangible assets, they do lose their ability to generate income after a certain period of time.²²⁴ Prior to the 1993 Act, the failure to reduce a business' income due to the expiration of the cost of intangible assets, which was allowed for tangible assets, resulted in the understatement of the business' economic cost of seeking profits and therefore resulted in the erroneous reflection of its income.²²⁵

2. The Mass-Asset Rule

The mass-asset rule²²⁶ seems to support the proposition that all customer-based intangibles are nondepreciable as a matter of law.²²⁷ However, the Fifth Circuit established in *Houston Chronicle, supra*, that the mass-asset rule does not provide a per se rule of nondepreciability whenever an intangible asset is related to goodwill.²²⁸ The test developed in *Houston Chronicle* is that an intangible asset can be depreciated "if the taxpayer properly carries his dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy."²²⁹

The IRS suggested that the *Houston Chronicle* test supports the notion that where an intangible asset is found to be separate and distinct from goodwill, it is depreciable, so that the *Houston Chronicle* Court did not intend to change the traditional definition of goodwill.²³⁰ The *Newark Morning Ledger* court of appeals pointed out that the large majority of authority weighs in favor of the IRS' interpretation of the *Houston Chronicle* test.²³¹ To illustrate, the court cited fourteen cases decided after *Houston Chronicle*.²³² However, the IRS only prevailed in six of the fourteen cited cases, which seems to discredit the argument that there is an enormous weight of authority in favor of the IRS' position.²³³

The court of appeals went further to suggest that the mass-asset rule is outdated, characterizing the recent cases involving the mass-asset rule as nothing but

223. For an illustrative example of how the pre-1993 Act tax law led to inequity in the treatment of similarly situated taxpayers, see Walburn, *supra* note 3, at 455-56.

224. Hollingsworth & Harrison, *supra* note 3, at 65.

225. Hollingsworth & Harrison, *supra* note 3, at 65. See *supra* notes 64-83 and accompanying text.

226. See *supra* notes 96-150 and accompanying text.

227. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1676-77 (1993).

228. *Id.*

229. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1250 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

230. *Newark Morning Ledger Co. v. United States*, 945 F.2d 555, 562 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993).

231. *Newark Morning Ledger*, 945 F.2d at 565.

232. *Id.* at 565-66.

233. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1679 n.12 (1993) (citing Reuven S. Aviyonah, *Newark Morning Ledger: A Threat to the Amortizability of Acquired Intangibles*, 55 TAX NOTES 981, 984 (1992)).

a “minority strand,”²³⁴ but the Supreme Court pointed out that the Tax Court still employs the rule as a guide to the treatment of certain intangible assets.²³⁵ More importantly, the IRS issued a ruling in response to *Houston Chronicle* asserting that customer-based intangible assets are not indistinguishable from goodwill as a matter of law, thereby accepting the possibility that an intangible asset, customer-based in nature, could be depreciated over its useful life.²³⁶

Supposing that the court of appeals rejected the mass-asset rule as outdated in order to discredit the *Houston Chronicle* test, the court of appeals’ argument is weak. The Supreme Court found that the case law developed since the *Houston Chronicle* decision in 1973 presents a persuasive approach in dealing with customer-based intangible assets.²³⁷ Together with the IRS’ ruling in response to the *Houston Chronicle* decision, the case law seems to establish a modern trend rather than a “minority strand.”

3. The Dissent’s View

The dissent’s basic argument was that there was a long-standing, congressionally-accepted treatment of goodwill and that the majority opinion was an attempt to rewrite the well-settled law in this area, thereby usurping Congress’ role.²³⁸ However, the majority stated that it had not changed § 1.167(a)-3 of the Regulations in the least.²³⁹ Rather, the Court stated that it had simply interpreted it to mean that if an intangible asset is found to have a reasonably-ascertained value and a limited useful life, it is by definition not goodwill, and therefore depreciable.²⁴⁰ This interpretation in no way changes the well-settled law, as it leaves intact the proposition that goodwill is nondepreciable under the Regulation.²⁴¹

The majority’s interpretation is well-supported when viewed in light of the plain language of the Regulation. The Regulation specifically states that intangible assets with limited lives may be subject to depreciation while intangible assets with indefinite lives – like goodwill – are not subject to depreciation.²⁴² It necessarily follows that goodwill has an indefinite life, and an intangible asset with a definite life is not goodwill. Therefore, an intangible asset with a definite life is subject to depreciation.

Secondarily, the dissent argues that by applying Newark’s position on the treatment of goodwill under § 167(a) of the Code, its expert testimony failed to prove the asset had the requisite definite life.²⁴³ Justice Souter pointed out that Newark’s

234. *Newark Morning Ledger*, 945 F.2d at 561, 565.

235. *Newark Morning Ledger*, 113 S. Ct. at 1677.

236. *Id.* (quoting Rev. Rul. 74-456, 1974-2 C.B. 65, 66).

237. *Id.* at 1680 n.12.

238. *Id.* at 1680 n.13.

239. *Id.*

240. *Id.* at 1680-81 & n.13.

241. *Id.* at 1680 n.13.

242. *See supra* note 24.

243. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1686, 1689 (1993) (Souter, J., dissenting). *See supra* note 193.

expert predicted the estimated life of the purchased asset combined with the customer satisfaction from Newark's post-sale efforts, thereby failing to prove the separate estimated life of the purchased asset at issue.²⁴⁴

While this argument appears valid, the problem lies in the failure of the Government to present any evidence in contradiction of Newark's expert testimony at the district court level.²⁴⁵ The Supreme Court pointed out that Newark faced a significant burden of proof, one that is often too great to overcome.²⁴⁶ However, Newark's evidence was the only evidence presented regarding the asset's useful life.²⁴⁷ Since the Government rested its entire case on a legal proposition that would later be rejected by the Supreme Court, the case was lost at trial.²⁴⁸

B. Implications – The Enactment of § 197

1. The Effect of § 197

In order to eliminate the dispute over the depreciability of goodwill faced by the Supreme Court in *Newark Morning Ledger*, the Revenue Reconciliation Act of 1993²⁴⁹ added a new section to the Code. Generally, § 197 requires that the cost of purchased intangible assets, including goodwill, be depreciated over a period of fifteen years.²⁵⁰ This new Code section effects a substantial change in the treatment of goodwill and is likely to have far-reaching implications.

Effective August 10, 1993, taxpayers are allowed to claim deductions for depreciation of "amortizable section 197 intangibles."²⁵¹ These intangible assets must be held in connection with a trade or business or for the production of income.²⁵² Section 197 applies regardless of whether an intangible asset is *purchased* as a part of a trade or business, subject to certain exceptions, as long as the asset is *used* in a business.²⁵³

Section 197 intangibles include, inter alia, goodwill and going-concern value, workforce in place, customer-based intangibles, and bank-deposit base.²⁵⁴ Since

244. *Newark Morning Ledger*, 113 S. Ct. at 1688 (Souter, J., dissenting).

245. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 182 (D.N.J. 1990), *rev'd*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993).

246. *Newark Morning Ledger*, 113 S. Ct. at 1681.

247. *Id.* at 1682 n.14.

248. *Id.*

249. Omnibus Budget Reconciliation Act of 1993, tit. XIII, ch. 1, subchapter B, pt. VI, Pub. L. No. 103-66, § 13261, 107 Stat. 312, 532-40 (1993).

250. RESEARCH INST. OF AM., THE RIA COMPLETE ANALYSIS OF THE REVENUE RECONCILIATION ACT OF 1993 ¶¶ 402, 2038 (1993) [hereinafter RIA].

251. *Id.* ¶¶ 401-02, at 85.

252. *Id.* ¶ 402, at 86. See I.R.C. § 167(a) (1988).

253. RIA, *supra* note 250, ¶ 402, at 86. Section 197 also provides for the depreciation of intangibles that are allowed to be treated as *acquired* under the Code. RIA, *supra* note 250, ¶ 402, at 86. For example, under § 338 a taxpayer can elect to treat a stock purchase as an asset purchase. RIA, *supra* note 250, ¶ 402, at 86. Section 197 would allow the taxpayer to depreciate this asset as long as it is held in connection with a trade or business or for the production of income. RIA, *supra* note 250, ¶ 402, at 86.

254. RIA, *supra* note 250, ¶ 402, at 86.

these assets are commonly purchased and sold in business transactions,²⁵⁵ § 197 will have a broad application and serve an important function in the planning of the acquisition of businesses.

Practically every business acquisition contains elements of goodwill and going-concern value. Goodwill is the value that attaches to the expectation that the customers of the purchased business will continue to do business with the acquiring company.²⁵⁶ Going-concern value is that value that attaches to the purchased business' ability to continue operating and producing income in light of the change in ownership.²⁵⁷ These elements are inherent in the purchase and sale of businesses and are often the basis for an increased purchase price. Although *Newark Morning Ledger* significantly altered the availability of depreciation for intangible assets, it did not change the per se ban on the depreciation of goodwill.²⁵⁸ Section 197 specifically provides for the depreciation of goodwill, a fact that allows taxpayers to depend on a favorable tax treatment of this asset when they are bargaining for the purchase of a business.²⁵⁹

Typically, purchasers of an ongoing business allocate a portion of the price to a workforce asset.²⁶⁰ Rather than having to hire and train a new workforce, the purchaser has an experienced, highly-skilled workforce on the date of acquisition.²⁶¹ Before the 1993 Act, the IRS viewed these assets as representative of the going-concern value of the business, making them nondepreciable.²⁶² Under § 197, these assets are subject to depreciation over fifteen years, including the costs of purchasing employee and consultant contracts.²⁶³

Another aspect of business valuation is that of assets which represent the existence of a real or potential customer base.²⁶⁴ This category includes subscription lists, investment management contracts, insurance in force, or other

255. See generally GARY S. BECKER, HUMAN CAPITAL 15-44 (2d ed. 1975); LESTER G. TELSER, COMPETITION, COLLUSION, AND GAME THEORY 356-57 (1972); Richard L. Doernberg & Thomas D. Hall, *The Tax Treatment of Going-Concern Value*, 52 GEO. WASH. L. REV. 353 (1984); D. Louis Glaser, *The Case for Parity Between Tax-Exempt and Nonexempt Purchasers in Asset Acquisitions*, 39 DEPAUL L. REV. 753 (1990).

256. RIA, *supra* note 250, ¶ 404. See *supra* notes 54-63 and accompanying text.

257. RIA, *supra* note 250, ¶ 404. The going-concern value of a business is deemed to exist as long as the business remains in operation. Hollingsworth & Harrison, *supra* note 3, at 55. For that reason, prior to the 1993 Act the cost of acquiring the going-concern value of a business could not be deducted as an expense for tax purposes, but had to be permanently capitalized. Hollingsworth & Harrison, *supra* note 3, at 55. See *infra* note 259 and accompanying text.

258. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1680 n.13 (1993).

259. RIA, *supra* note 250, ¶ 403, at 88. Annual depreciation deductions are always preferable to deductible losses or reductions in taxable gain on the sale of a business because annual deductions allow a taxpayer to reduce its current tax liability each year while the acquired business is in operation. Walburn, *supra* note 3, at 471. A deductible loss or reduction in taxable gain becomes beneficial only upon sale of the business, which may occur several years in the future. Walburn, *supra* note 3, at 471. By receiving a current year deduction as opposed to a deduction in the future, a taxpayer can either use the then-available funds for investment purposes or to meet immediate cash needs. Walburn, *supra* note 3, at 471.

260. RIA, *supra* note 250, ¶ 406.

261. RIA, *supra* note 250, ¶ 406.

262. RIA, *supra* note 250, ¶ 406. See *supra* note 257 and accompanying text.

263. RIA, *supra* note 250, ¶ 406.

264. RIA, *supra* note 250, ¶ 413.

representations involving the future provision of goods or services to customers.²⁶⁵ One hallmark of a business entity is that it generally operates on the support of customer relationships, whether the customers are wholesalers, retailers, ultimate consumers, clients, or patients. Under § 197, the cost of customer-based intangibles is depreciable per se, and the taxpayer is not required to establish a useful life or separate value for them.²⁶⁶

An important inclusion under § 197 intangibles for financial institutions is that of deposit base.²⁶⁷ Deposit base has been classified as a customer-based asset, and was therefore, prior to the 1993 Act, only depreciable to the extent that it was proven to have a separate value and useful life.²⁶⁸ Section 197 provides for an automatic depreciation allowance for the core deposit base of financial institutions.²⁶⁹

2. Self-Created Intangibles

Prior to the 1993 Act, if a taxpayer incurred costs to create, maintain, or enhance an intangible asset's value, those costs could be currently deducted from income as an ordinary and necessary business expense.²⁷⁰ Such costs include, inter alia, advertising expenses, research and experimental costs, and costs incurred to train employees.²⁷¹ Section 197 excludes self-created intangibles, subject to exceptions,²⁷² and in effect retains the prior rules regarding current deduction of costs.²⁷³ In essence, a taxpayer must capitalize the cost of purchasing an intangible asset, but may currently deduct the cost of creating or maintaining it.²⁷⁴

Section 197 offers an added benefit by retaining the prior rules. Typically, taxpayers will prefer an allowance for a current expense deduction over a capital expenditure because the current expense deduction will offset current income resulting in a lower current tax obligation. On the other hand, the taxpayer that capitalizes an expense will add that expense to the basis of the affected asset and recover its cost through later depreciation deductions.

265. RIA, *supra* note 250, ¶ 413.

266. RIA, *supra* note 250, ¶ 413.

267. RIA, *supra* note 250, ¶ 415. *See supra* note 131.

268. RIA, *supra* note 250, ¶ 413.

269. RIA, *supra* note 250, ¶ 415.

270. RIA, *supra* note 250, ¶ 427. *See supra* note 59.

271. RIA, *supra* note 250, ¶ 427.

272. Covenants not to compete that are made upon acquiring an interest in a trade or business, trademarks and tradenames, franchises, and certain government-granted licenses and permits are self-created intangibles which are depreciable under § 197. RIA, *supra* note 250, ¶ 427.

273. RIA, *supra* note 250, ¶ 427. Prior to the 1993 Act, two similarly situated taxpayers—a developer of goodwill and a purchaser of goodwill—were treated differently by the law. Walburn, *supra* note 3, at 470. A developer of goodwill was allowed to immediately deduct expenditures made for the creation of goodwill, like advertising and research and development costs. Walburn, *supra* note 3, at 470. Because the developer may not yield significant revenues for several years, it typically was able to defer the recognition of revenue created by these expenditures to future years. Walburn, *supra* note 3, at 470. These rules of law are still in effect. RIA, *supra* note 250, ¶ 427.

On the other hand, the purchaser of goodwill was denied current depreciation deductions and would normally expect revenue to be generated by the goodwill immediately after the purchase of an ongoing, profitable business. Walburn, *supra* note 3, at 470.

274. RIA, *supra* note 250, ¶ 427. *See supra* note 59.

As a result of § 197, taxpayers not only get a specific, newly-created allowance for depreciation of goodwill, but they also get to adhere to the pre-1993 Act rules allowing for current deduction of expenses incurred in creating and maintaining goodwill.²⁷⁵ By granting new deductions and allowing for deductions that only serve to preserve goodwill for the future, § 197 offers a tangible benefit to taxpayers.

3. The Pros and Cons of § 197

Under § 197 all intangible assets must be depreciated over fifteen years, regardless of whether the asset's useful life is more or less than fifteen years.²⁷⁶ This benefits purchasers of intangible assets which, prior to the 1993 Act, were depreciated over useful lives longer than fifteen years because they are able to recover their cost more quickly. Also, § 197 provides for a previously non-existent depreciation deduction for goodwill.²⁷⁷

Another benefit provided by § 197 is the elimination of controversy over the allowance of depreciation for certain intangible assets, as evidenced by *Newark Morning Ledger*.²⁷⁸ Section 197 intangibles are usually allotted a large monetary value, and § 197 provides purchasers of businesses a degree of certainty about how the intangible asset will be treated for tax purposes.²⁷⁹

Section 197 employs the residual method of valuing intangible assets.²⁸⁰ This method requires that the purchase price of a business first be allocated to assets other than § 197 intangibles.²⁸¹ The excess, or residual, amount is then allocated to all § 197 intangibles.²⁸²

When a taxpayer has purchased a group of § 197 intangible assets and suffers a loss on one of those assets, either through disposition, worthlessness, or abandonment, § 197 bars the taxpayer from taking a current loss deduction until the taxpayer disposes of the last asset in the group of intangibles acquired in the purchase.²⁸³ On the other hand, gain will have to be recognized on the disposition of each individual intangible asset.²⁸⁴ For this reason, separate valuation and identification of each § 197 intangible purchased in a group will be necessary to determine whether a subsequent disposition results in a recognizable gain, or a loss that must be deferred.²⁸⁵ For practical reasons, it is safe to assume that one or more intangibles that were acquired in a group will be disposed of within a fifteen-year

275. RIA, *supra* note 250, ¶ 427. See *supra* note 273 and accompanying text.

276. RIA, *supra* note 250, ¶ 403.

277. RIA, *supra* note 250, ¶ 403.

278. RIA, *supra* note 250, ¶ 403.

279. RIA, *supra* note 250, ¶ 403.

280. RIA, *supra* note 250, ¶ 402, at 87.

281. RIA, *supra* note 250, ¶ 402, at 87.

282. RIA, *supra* note 250, ¶ 402, at 87.

283. RIA, *supra* note 250, ¶ 402, at 87. See Levy, *supra* note 3, at 8.

284. Levy, *supra* note 3, at 8.

285. Levy, *supra* note 3, at 8.

period—the statutory lifetime for § 197 intangibles.²⁸⁶ As a result, it would be wise for taxpayers to have a contemporaneous valuation of assets upon acquisition of a business.²⁸⁷

Also, this feature can be viewed as a negative effect of § 197 because the taxpayer will not be able to reduce its taxable income by a current deduction for the loss. However, the basis in the remaining group of intangible assets is increased by the amount of the loss that is disallowed.²⁸⁸ This still results in recovery of the taxpayer's cost, just over a longer period of time through depreciation deductions.

4. The Effect on One Who Sells a Business

An important factor in any transaction affecting the purchase of a business is the tax consequences afforded the assets being purchased.²⁸⁹ These tax consequences often affect the amount a buyer is willing to pay for a business.²⁹⁰ To this end, § 197 has an impact not only on the purchaser of a business, but also on the seller.²⁹¹

With the enactment of § 197, a buyer today may be willing to pay more for a business.²⁹² Prior to the 1993 Act, goodwill was per se nondepreciable under Treasury Regulation § 1.167(a)-3.²⁹³ Therefore, the value of the goodwill asset of a business would be diminished in the eyes of the purchaser of a business because it would not be able to recover the asset's purchase price through subsequent depreciation deductions. Section 197 now allows for recovery of this cost through depreciation, making the asset more valuable to the purchaser,²⁹⁴ thereby allowing the seller of a business to command a higher purchase price.

However, there is a converse effect. Section 197 provides for a uniform fifteen-year depreciation period, regardless of the actual useful life of the asset.²⁹⁵ If, under § 197, the asset is prescribed a longer useful life than it actually has, a buyer

286. Levy, *supra* note 3, at 8.

287. Levy, *supra* note 3, at 8.

288. RIA, *supra* note 250, ¶ 429, at 104. If the remaining basis in the assets was not increased by the disallowed loss, the taxpayer would never recover the entire basis of the loss asset. CRUMBLY, *supra* note 8, at 14-18. See Levy, *supra* note 3, at 8.

289. RIA, *supra* note 250, ¶ 403. Prior to the 1993 Act, the buyer and seller in an acquisition transaction would have differing views on the valuation of the assets being purchased. The buyer would have preferred that the purchase price be allocated to assets that would give rise to current or future tax deductions, such as depreciable tangible assets. Walburn, *supra* note 3, at 477 n.117. While not likely, the buyer would have preferred a zero allocation to goodwill since the cost of that asset could not have been recovered until the business was sold or terminated. Walburn, *supra* note 3, at 477 n.117. See *supra* note 34. On the other hand, the seller would have preferred that as much of the purchase price as possible be allocated to goodwill, rather than depreciable tangible assets, because it would have received capital gain treatment on the sale of its goodwill as opposed to ordinary income on the sale of most of its other assets. Walburn, *supra* note 3, at 477 n.117. See also CRUMBLY, *supra* note 8, at 16-25 to 16-26.

290. RIA, *supra* note 250, ¶ 403.

291. RIA, *supra* note 250, ¶ 403.

292. RIA, *supra* note 250, ¶ 403.

293. See *supra* note 24.

294. RIA, *supra* note 250, ¶ 403.

295. RIA, *supra* note 250, ¶ 403.

may insist on paying less.²⁹⁶ Since the cost recovery period will be longer, the buyer will recover his cost less quickly than before the Act. Assuming all taxpayers want to reduce their current tax obligations as much as possible and taking into account the time value of money,²⁹⁷ the value of assets with a shorter pre-1993 Act useful life will be reduced.²⁹⁸

5. The Effect on Professional Practices

A large portion of the purchase price of a professional practice, such as a medical, dental, or law practice, is typically allocated to goodwill.²⁹⁹ Generally, a minor portion of the price is allocated to the tangible assets of the practice, with the remainder considered goodwill.³⁰⁰ Prior to the 1993 Act, this large cost would be nondepreciable to the purchaser of a professional practice.³⁰¹

Professional practices are not referred to under § 197, but there is no indication that the goodwill associated with the purchase of a professional practice would be treated any differently.³⁰² As a result, professionals may now be able to take depreciation deductions for the largest portion of the acquisition cost of their practice that before were unavailable. These deductions will result in a tremendous tax savings to purchasers of professional practices. While § 197 may require that professionals be willing to pay more for their practices with their increase in value due to future allowable depreciation,³⁰³ the potential tax savings may well outweigh any increase in purchase price.

VI. CONCLUSION

Relying on the plain language of § 167 of the Code and the underlying case law, the Supreme Court reached a logical decision in *Newark Morning Ledger*. Its interpretation of the applicable Regulation was rational and consistent with the IRS' position on the depreciability of intangible assets.

Giving merit to the Court's decision, Congress passed the Revenue Reconciliation Act of 1993, allowing for the depreciation of goodwill and other related intangible assets.³⁰⁴ The new Code section created by that Act has far-reaching effects on the tax treatment of certain intangible assets, as well as the overall transactions related to acquiring a business.

296. RIA, *supra* note 250, ¶ 403.

297. Typically, taxpayers "would prefer having a dollar today rather than at some future date because (1) the risk exists that the future dollar will never be received; and (2) if the dollar is on hand now it can be invested, resulting in an increase in total dollars possessed at that future date." HERMANSON, *supra* note 6, at 720. This is the concept of the time value of money. HERMANSON, *supra* note 6, at 720. Current deductions from income serve to reduce a taxpayer's current tax obligation, which in turn increases the taxpayer's current spendable income. Thus, there is a logical preference for a dollar today rather than tomorrow. HERMANSON, *supra* note 6, at 720.

298. RIA, *supra* note 250, ¶ 403.

299. RIA, *supra* note 250, ¶ 405.

300. RIA, *supra* note 250, ¶ 405.

301. RIA, *supra* note 250, ¶ 405. See *supra* notes 84-95 and accompanying text.

302. RIA, *supra* note 250, ¶ 405.

303. See *supra* notes 289-98 and accompanying text.

304. RIA, *supra* note 250, ¶ 402.

With the opinion handed down by the Supreme Court in *Newark Morning Ledger* and the subsequent enactment of § 197, the often-litigated issue of whether goodwill can be depreciated for tax purposes has been put to rest.³⁰⁵ The answer to that question is a resounding yes!

305. In light of the decision handed down in *Newark Morning Ledger*, taxpayers that took conservative positions with regard to customer-based intangibles during any taxable years still open to amendment should file amended tax returns for those years. *Levy, supra* note 3, at 10. However, the IRS may try to dispute the taxpayer's allocation of the purchase price of a business between tangible assets and depreciable intangible assets since the statutory period for the latter—15 years—is longer than the recovery period of most tangible assets. *Walburn, supra* note 3, at 483 n.144.