SHOPPING FOR INTANGIBLES AT THE MALL: THE IMPACT OF SECTION 197 ON THE ACQUISITION OF RETAIL RENTAL REAL ESTATE

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I. Introduction

The purpose of this Article is to explore the potential effects of section 197 of the Internal Revenue Code (I.R.C.)[1] on the acquisition of retail rental real estate. Section 197, enacted as part of the Omnibus Budget Reconciliation Act of 1993,[2] has fundamentally altered the tax planning incident to the acquisition of intangible assets. The most noteworthy feature of this provision is its establishment of a mandatory fifteen-year recovery period for assets that fall within its ambit.[3] Section 197 will, for most taxpayers, prove to be a significant improvement over prior law.[4] This Article will explore the potential application of section 197 in the context of the acquisition of a regional shopping center.

Part II of this Article presents a detailed analysis of section 197. The discussion begins with a brief background of the law as it existed prior to the enactment of section 197 and the purpose for its enactment. Next, a detailed analysis of the statute is presented, followed by an examination of whether the statute has, for all practical purposes, eviscerated goodwill and going concern value of independent significance.

Part III explores the application of section 197 to the retail rental real estate industry. In general, this industry has avoided the tortured and expensive process of intangible asset valuation typi-

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1 Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1986 (I.R.C.), as amended.

2 Pub. L. No. 103-66, 107 Stat. 312 (1993).

3 I.R.C. § 197(a) (West 1994).

4 In fact, there are those of the opinion that § 197 is too much of an improvement over prior law. Senator Paul Simon has introduced legislation that would reduce annual amortization deductions pursuant to § 197 by 25%. S. 1699, 103d Cong., 1st Sess. § 1(a) (1993) (providing that 75% of the adjusted basis of amortizable § 197 assets is subject to amortization).

cally undertaken by parties to acquisitions of other types of businesses. In most cases, the central valuation issue in the acquisition of real estate assets has been the allocation of the purchase price between land and depreciable building improvements, the absence of significant intangible assets being a foregone conclusion. The basic argument presented is that, conceptually, the acquisition of rental real estate should be approached no differently than acquisitions of other types of enterprises. The existence and relative importance of intangible assets in any transaction is an inherently factual issue and chimerical resort to doctrinal distinctions should be avoided.

Part III also examines the nature and operation of the industry and identifies assets that may qualify for amortization pursuant to section 197. The new regime can be very beneficial to an acquirer of a retail rental real estate business. The fifteen-year recovery period mandated by section 197 contrasts favorably with the Modified Accelerated Cost Recovery System rules. These rules require that the tax basis of non-residential real property[5] be recovered over a period of thirty-nine years.[6] As a result, there exists ample incentive for prospective acquirers to undertake the process of identifying assets to which section 197 will apply.

Part IV analyzes several collateral implications with respect to the application of section 197. First, the peculiarities inherent in the tax law of partnerships will be examined for their effect on working with the new intangibles legislation. Moreover, the new rules may have significance beyond their effect on taxable income. Existing or prospective agreements could be impacted and these consequences should be understood and planned for appropriately. Finally, section 197 will have significant consequences upon disposition of the acquired business. In general, this could very well be the one area where the new rules are decidedly negative.

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5 Nonresidential real property is defined as § 1250 property which is neither residential rental property nor property that has a class life of less than 27.5 years. I.R.C. § 168(e)(2)(B) (1988). Residential rental property is defined as a building or structure generating 80% or more of its gross rental income for the taxable year from dwelling units. Dwelling units are defined to exclude hotel, motel, or other establishments that use more than one-half of its units on a transient basis. *Id.* § 168(e)(2)(A) (Supp. IV 1992).

6 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,151, 107 Stat. 312, 448 (1993) (amending I.R.C. § 168(c)(1)(West 1993)). The Act extended the recovery period of nonresidential real property to 39 years, from 31.5 years, for property placed in service on or after May 13, 1993. Several transition rules are provided that extend the effective date of the change to January 1, 1994. *See id.* § 13,151(b)(2).

II. Section 197: The Statutory Framework

A. *The Prelude to Section 197*

Intangible assets have always been an important factor in the success of an enterprise. From the corner grocer's pleasant demeanor to the ubiquitous "Coca-Cola" trademark, these assets represent a significant element of value to an enterprise in addition to the value resulting from the deployment of tangible assets. When the assets of an acquired enterprise[7] include intangible assets, prudent tax planning has often focused on the allocation of tax basis to those intangible assets whose basis may be recovered through periodic amortization deductions.[8] Prior to the enactment of section 197, the operative rule governing the amortization of intangible assets was provided by Treasury Regulation section 1.167(a)-3. In general, if the useful life of an intangible asset could be estimated with reasonable accuracy, then the asset in question could be amortized.[9] Goodwill was categorically excluded from the class of amortizable assets.[10] Two broad issues presented themselves concerning intangible assets acquired as part of the purchase of an on-going enterprise. First, it was necessary to identify the type and nature of the intangible assets acquired. Second, after the identification process was complete, it became necessary to allocate a por-

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[7] An acquisition of stock, coupled with a § 338 election, will raise identical issues. A corporate purchaser of stock may elect to apply § 338 if it acquires the target in a qualified stock purchase. I.R.C. § 338(g) (1988). A qualified stock purchase is defined as a transaction or series of transactions in which 80% or more of the total voting power and value of the target's stock is acquired during a twelve month period. *Id.* § 338(d)(3). If a § 338 election is made, the target is deemed to have sold its assets at fair market value to a new corporation. *Id.* § 338(a); *see also id.* § 338(h)(10) (providing for an election by both buyer and seller that treats the target member of a consolidated return as selling its assets to a new corporation and liquidating into a member of the selling group pursuant to § 332).

[8] The terms "amortization" and "depreciation" are often used interchangeably. I use the term "amortization" to refer to the periodic cost recovery of intangible assets, limiting the use of the term "depreciation" to refer to the periodic cost recovery of tangible assets.

[9] Treas. Reg. § 1.167(a)-3 (as amended in 1960) provides, *inter alia,* as follows:

> 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. . . . 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 good will.

Id.

[10] *Id.*

tion of the purchase price to the individual intangible assets acquired.

1. Identification of the Assets Acquired

Disputes often arose between taxpayers and the Internal Revenue Service (IRS) as to whether particular intangible assets met the standards promulgated by Treasury Regulation section 1.167(a)-3.[11] Taxpayers had proven to be quite creative in identifying a variety of intangible assets that allegedly met the requirements for amortization.[12] The IRS attempted to justify its denial of amortization deductions through the use of a per se rule, the so-called mass asset rule. The theory underpinning this rule was that certain intangible assets are part of a single, self-regenerating asset with no determinable useful life or, alternatively, are indistinguishable from goodwill.[13] This theory, surfacing as early as 1925,[14] had enjoyed some success, particularly with respect to customer-based intangibles.[15] However, beginning in the early 1970s, the continuing

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11 One commentator has stated that *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670 (1993), discussed *infra* note 20 and accompanying text, would be the one hundred twentieth case dealing with the issue of whether an intangible asset may be amortized. *See* Michael R. Schlessinger, Indopco *&* Newark: *Defining the Intangible "Asset" in the Larger Cost Recovery Context*, 70 TAXES 929 (1992) (citing a New York State Bar Association report on proposed legislation involving the amortization of intangibles).

12 *See, e.g.*, Jon Dean Kitchel, *A Tax Policy Analysis of Recent Legislative Proposals Regarding the Treatment of Goodwill*, 92 TAX NOTES TODAY 252-89, App. A, Dec. 18, 1994, *available in* LEXIS Fedtax Library, TNT file (listing over 150 types of intangible assets that have been claimed by taxpayers).

13 The IRS has also asserted that denial of amortization deductions for certain intangible assets is justified on the grounds that such denial is necessary to prevent double deductions to taxpayers. This theory is premised on the fact that certain expenses, such as marketing, advertising, and employee training, are currently deductible notwithstanding the fact that they contribute to the creation or enhancement of intangible assets with future value. *See Purchase Price Allocations and Amortization of Intangibles*, 209-4th Tax Mgmt. (BNA), at A-29. Conceptually, an inverse relationship should exist between the estimated useful life of an asset and the level of future expenditures related to that asset that are capitalized. If periodic repairs are frequent, the asset should have a longer useful life, whereas the replacement of assets by periodic improvements would suggest a shortened useful life for the original asset.

This relationship, however, may not hold for several reasons. For example, the repair versus capitalization decision may be made without any consideration of the original useful life established for the asset. Moreover, the timing of the expenditures may have distortive effects on this relationship. *See* Schlessinger, *supra* note 11, at 933-34. The recent Supreme Court decision in *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992), may ultimately serve to discredit this theory. *See infra* note 71.

14 *See* Danville Press, Inc., 1 B.T.A. 1171 (1925) (holding that unexpired newspaper subscriptions were a single nondepreciable asset).

15 *See, e.g.*, Decker v. Commissioner, 864 F.2d 51 (7th Cir. 1988); Winn Dixie Montgomery, Inc. v. United States, 444 F.2d 677 (5th Cir. 1971); Marsh & McLennan, Inc.

vitality of this theory was called into question.

The mass asset rule was dealt a significant set back in *Houston Chronicle Publishing Co. v. United States.*[16] In that case, the Fifth Circuit established a two-prong test for determining whether an intangible asset was amortizable. First, the asset must have an ascertainable cost basis separate and distinct from goodwill and going concern value. Relevant factors examined in determining whether this test was met included a clear identification of the asset, a means of valuing it, a market for isolated sales of similar assets, and arms-length bargaining for the particular asset.[17] Second, the intangible asset must have an ascertainable useful life.[18] This two-pronged test changed the nature of the inquiry to a factual one that many taxpayers were able to satisfy.[19]

In 1993, the Supreme Court decided *Newark Morning Ledger Co. v. United States.*[20] At issue in the case was whether the purchaser of all the stock of a newspaper publisher, after liquidating the acquired corporation, could amortize approximately $68 million allocated to the acquired newspapers' subscribers.[21] The Court, in a 5-4 decision reversing the Third Circuit, rejected the IRS's mass asset argument and applied a two-pronged test essentially equivalent to the one adopted by the Fifth Circuit in *Houston Chronicle.* The majority opinion unambiguously adopted a factual test for determining whether intangible assets are amortizable, stating:

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v. Commissioner, 420 F.2d 667 (3d Cir. 1969); Boe v. Commissioner, 307 F.2d 339 (9th Cir. 1962).

16 481 F.2d 1240 (5th Cir. 1973), *cert. denied,* 414 U.S. 1129 (1974).

17 *See Purchase Price Allocations and Amortization of Intangibles, supra* note 13, at A-19-20 (collecting and discussing cases where the taxpayers prevailed in their attempt to amortize purchased intangible assets).

18 The factors that are used to prove a limited useful life are as varied as the assets for which disputes arise. This particular issue lends itself to a "battle of experts." Taxpayers, however, were on notice that use of purely historical data in support of a limited useful life may be insufficient and that evidence projecting a useful life to existing assets would be required. *Compare* Banc One Corp. v. Commissioner, 84 T.C. 476 (1985), *aff'd,* 815 F.2d 75 (6th Cir. 1987) (holding that exclusive reliance on historical experience in establishing a useful life for deposit base intangibles was inadequate) *with* Citizen and S. Corp. v. Commissioner, 91 T.C. 463 (1983), *aff'd,* 900 F.2d 266 (11th Cir. 1990) (holding that the taxpayer met its burden of proof in establishing a limited useful life for deposit base intangible through, *inter alia,* use of prospective analysis of depositor behavior).

19 *See Purchase Price Allocations and Amortization of Intangibles, supra* note 13 at A-21 n.173 (collecting cases in which the taxpayer prevailed in distinguishing intangible assets from goodwill).

20 113 S. Ct. 1670 (1993).

21 The taxpayer liquidated the target pursuant to I.R.C. § 334(b)(2). *See id.* at 1672. This provision, repealed in 1982, served as the predecessor to § 338, although it differed from § 338 in several major respects.

> It must follow that if a taxpayer can prove with reasonable accuracy that an asset used in a trade or business or held in the production of income has a value that wastes over an ascertainable period of time, that asset is depreciable under § 167, regardless of the fact that its value is related to the expectancy of continued patronage.[22]

This language could be interpreted to mean that certain intangible assets, indistinguishable from goodwill, may be amortizable provided that an ascertainable useful life is proven. However, the Court reasoned that any intangible asset that has a limited useful life and a separate ascertainable value is categorically excluded from the definition of goodwill.[23]

The *Newark Morning Ledger* decision has been viewed as the death of the mass asset rule in connection with customer-based intangibles.[24] Unfortunately, the decision left lingering doubts about the role of the mass asset rule with respect to other intangible assets.[25] Moreover, the majority opinion noted the difficulty of using existing definitions of goodwill in grappling with the issue of whether a particular intangible asset is amortizable.[26] The definition of goodwill is an issue that may not have been put completely to rest by the enactment of section 197.[27]

2. Allocation of Purchase Price Among the Assets Acquired

Several possible methods exist for allocating the purchase price of a group of assets among the individual components ac-

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22 *Id.* at 1680-81.

23 *Id.* at 1680 n.13.

24 *See, e.g.*, Marc D. Levy et al., *Supreme Court's Decision on Amortizing Intangibles Removes One Barrier*, 79 J. TAX'N. 4 (1993); George L. Middleton Jr. & Christian M. McBurney, *The Morning After* Newark Morning Ledger: *What Should Taxpayers Do Now?*, 59 TAX NOTES 817 (1993).

25 The Court cited *Ithaca Industries, Inc. v. Commissioner*, a case in which the Tax Court accepted the application of the mass asset rule to an assembled work force. *See Newark Morning Ledger*, 113 S. Ct. at 1677 (citing Ithaca Indus., Inc. v. Commissioner, 97 T.C. 253 (1991)) (suggesting that the Third Circuit may have been presumptuous in asserting that the mass asset rule was outdated).

26 Justice Blackmun's majority opinion stated that the accepted definitions of goodwill were of little use in resolving the issue because "[t]he value of every intangible assets is related, to a greater or lesser degree, to the expectation that customers will continue their patronage." *Id.* at 1675-76 (footnote omitted). Moreover, the difficulty of distinguishing between goodwill and going concern value was highlighted by the Court's choice of *Ithaca Industries* as support for the possible continuing vitality of the mass asset rule. *See id.* at 1677 (citing Ithaca Indus., Inc. v. Commissioner, 97 T.C. 253 (1991)). At issue in *Ithaca Industries* was an assembled work force, an asset that is regarded by many as part of going concern value. *See supra* note 25 and *infra* note 188 and accompanying text.

27 *See infra* notes 201-07 and accompanying text.

quired. First, the individual assets could be allocated their individually appraised value and any excess or shortfall in the price relative to the sum of individually appraised assets could be reallocated back to the assets in proportion to the fair market value.[28] This method—the so-called second tier or step method—treats all tangible and intangible assets similarly and requires an appraised value for goodwill and going concern value. Goodwill and going concern value then share in the second tier or step allocation with all other assets. A second method of allocation is the "residual method." This method does not attempt to assign an independent value to goodwill and going concern value. Instead, any excess of the price of the assets over the fair market value of the identified tangible and intangible assets, other than goodwill and going concern value, is assigned to the latter.[29]

In early 1986, temporary regulations were issued under section 338 that mandated the use of the residual method of allocation in the case of a stock purchase for which a section 338 election is made.[30] Later in the same year section 1060 was enacted as part of the Tax Reform Act of 1986.[31] Section 1060 mandates the use of the residual method in the case of an "applicable asset acquisition" by expressly adopting the allocation rules provided for in section 338.[32] An "applicable asset acquisition" is defined as any transfer of assets constituting a trade or business whose basis is determined wholly by reference to the consideration paid for tne assets.[33] Regulations issued under section 1060 state that the determination of whether assets constitute a trade or business is to be made by reference to the use of the assets by either the buyer or the seller.[34]

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28 Cash and cash equivalents are excluded from the second tier allocation. *See* Rev. Rul. 77-456, 1977-2 C.B. 102.

29 *See, e.g.*, Jack Daniel Distillery v. United States, 379 F.2d 569 (Ct. Cl. 1967). Moreover, generally accepted accounting principles subscribe to this method. INTANGIBLE ASSETS, Accounting Principles Bd. Opinion No. 17, ¶ 26 (Accounting Principles Bd. 1970).

30 Temp. Treas. Reg. § 1.338(b)-2T (1986).

31 Pub. L. No. 99-514, § 641(a), 100 Stat. 2320 (1986).

32 I.R.C. § 1060(a) (1988 & Supp. IV 1993). Section 1060(b) also provides for a reporting mechanism to enable the IRS to scrutinize transactions subject to its provisions. Moreover, if the parties to the transaction agree to an allocation of the price among the assets transferred or to the fair market value of any of the assets, such agreement will be binding upon the parties unless the party refuting the allocation or valuation presents admissible proof of fraud, duress, mistake, or other contract formation defenses. *See id.*; Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967). The IRS, however, is not bound by the agreement if it finds the allocation or fair market value agreed upon not appropriate. I.R.C. § 1060(a).

33 I.R.C. § 1060(c) (1988).

34 *See infra* note 108 and accompanying text.

Moreover, an "applicable asset acquisition" will result from the acquisition of assets if goodwill or going concern value could attach to those assets under any circumstances.[35]

The residual method employed by section 1060 segregates assets into four classes—termed Classes I through IV. Class I assets are cash, demand deposits, and like accounts in financial institutions, as well as assets that may be designated as such by the IRS.[36] Class II assets are certificates of deposit, United States government securities, marketable stock or securities, foreign currency, and other assets so designated by the IRS.[37] Class III are all other assets, tangible and intangible, that are not included in Classes I, II, or IV.[38] Class IV assets are intangible assets in the nature of goodwill and going concern value.[39]

The purchase price paid for the assets is allocated sequentially among the asset classes, beginning with Class I.[40] Any excess of the purchase price paid over the fair market value of the assets in that class is allocated to the next class. As a result, goodwill and going concern value always obtain a residual valuation.[41] In the event, less than the full fair market value of the assets is allocated to class II or III, the individual assets within the class are allocated a prorata share, based on fair market values, of the total price allocated to the class.[42] If a portion of the purchase price is contingent, for example, on profitability or other factors, then the contingent element is not allocable to the assets until such time as the contingent amount becomes fixed.[43] The adjustment to the purchase price

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35 *See infra* note 116 and accompanying text.

36 Temp. Treas. Reg. § 1.1060-1T(d)(1) (1988).

37 *Id.* § 1.1060-1T(d)(2)(i).

38 *Id.* § 1.1060-1T(d)(2)(ii).

39 *Id.* § 1.1060-1T(d)(2)(iii). For a discussion of the effect of § 197 on the classification of assets pursuant to § 1060, see *infra* notes 47-49 and accompanying text.

40 Temp. Treas. Reg. § 1.1060-1T(d) (1988).

41 A residual valuation may also result for Class II and III assets in a situation where the purchase price of the assets is less than the appraised value of the identifiable tangible and intangible assets. This result could arise, for example, from an acquisition heavily laden with contingent purchase price elements. Because contingent consideration is not allocable to the assets acquired until the contingent amount is fixed, the amounts initially allocated to the assets, exclusive of the contingent amounts, may be less than the appraised value of Class I, II, and III assets. *See infra* note 43 and accompanying text. For a discussion of the problems this result may cause and several techniques to mitigate these problems see Martin D. Ginsburg & Jack S. Levin, 1 Mergers, Acquisitions, and Leveraged Buyouts ¶ 403 (CCH Tax Trans. Lib. 1993). A residual allocation to Class II or III assets may also result from hard bargaining with a distressed seller.

42 Temp. Treas. Reg. § 1.1060-1T(d)(2) (1988).

43 *Id.* § 1.1060-1T(f); *id.* § 1.338(b)-3T(c)(1).

will result in a reallocation of basis to the assets as if the contingent amount was incurred at the acquisition date.[44] One important consequence of the enactment of section 197 is the elimination of the risk that unexpectedly large contingent payments will result in the creation of, or addition to, a non-amortizable asset.[45] An exception to the general reallocation rule is made in the case where the contingency relates to specific income-producing intangible assets, such as patents or copyrights. Adjustments relating to these assets are made directly to the assets in question.[46]

The impact of section 197 on section 1060 is not entirely clear. It appears that amortizable section 197 assets should not be commingled with other assets, as they are now in Class III. Future regulations will provide that Class IV assets encompass all amortizable section 197 assets and not merely goodwill and going concern value.[47] Although it is arguable that cost segregation among the individual assets comprising amortizable section 197 assets is generally not necessary, the classification of all amortizable section 197 assets as Class IV assets, without distinction, could lead to unintended results. For example, if a contingent purchase price formula leads to an increase or decrease in the price paid for the assets then the failure to distinguish among the components of

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44 *Id.* § 1.1060-1T(f)(2)-(3).

45 In the event the contingency yields an increase in the purchase price, Class IV will absorb the entire adjustment so long as Class III assets have been allocated their full fair market value. Conversely, a decrease in consideration will result in a decrease to the basis of goodwill and going concern value before affecting other assets. If the allocation of contingent amounts results in an increase in basis to assets subject to cost recovery under § 168 the increase in basis is recoverable over the remaining years in the asset's recovery period. *See id.* § 1.338(b)-3T(d)(2); Prop. Treas. Reg. § 1.168-2(d)(3), 49 Fed. Reg. 5940 (1984). Note that the original issue discount rules may require that a portion of the contingent payment be recharacterized as interest by discounting the contingent payments back to the acquisition date. *See* Prop. Treas. Reg. § 1.1275-4(c)(3)(ii), 51 Fed. Reg. 12,022, 12,087 (1986). This recharacterization is usually favorable to a buyer because it results in a current deduction for the portion of the payment recharacterized as interest.

46 Temp. Treas. Reg. § 1.1060-1T(f)(4) (1988). For purposes of applying the fair market value limitation rule to these assets, their fair market values are also adjusted by the contingent amounts. *See id.* § 1.1060-1T(f)(4)(ii).

47 *See* STATEMENT OF CONFERENCE MANAGERS FOR THE REVENUE PROVISIONS OF TITLE XIII OF THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993, H.R. REP. No. 103-213, 103d Cong., 1st Sess. 213 (1993) *reprinted in* The Revenue Reconciliation Act of 1993 (R.I.A. U.S. Tax Rep. Supp. 1993) [*hereinafter* Conference Rep.]. Two amendments to § 1060 resulted from the enactment of § 197. The first amendment requires that information with respect to § 197 intangibles be reported in place of the goodwill and going concern information. I.R.C. § 1060(b)(1) (1988). Second, § 1060 is made applicable for purposes of determining the fair market value of § 197 intangibles in connection with a transaction to which § 755 applies. *Id.* § 1060(d)(1).

amortizable section 197 intangible assets will cause a basis adjustment to all assets within the class even though that result clearly should not apply.[48]

Moreover, to avoid an independent appraisal of goodwill and going concern value, it will probably be necessary to treat these two assets separately from other amortizable section 197 assets, either as a sub-component of Class IV or as a new Class V. This will be necessary because the allocation of basis among assets within a class is based upon the relative fair market values of the constituent assets. Continuing to segregate goodwill and going-concern value allows these assets to take the final residual allocation without resort to appraisals. This argument assumes, of course, that segregating the basis among amortizable section 197 assets will have potential consequences apart from the effect such segregation will have on balance sheet presentation.[49]

As the preceding discussion highlights, the state of the law regarding the amortization of intangible assets was fraught with ambiguity and uncertainty. In addition to the obvious benefits of eliminating, or at least reducing, the risk of potential litigation, many commentators have put forth other reasons in support of a legislative solution to the problems attendant to the amortization of intangible assets.[50] Tax neutrality and efficiency were often the reasons given for the clamor for a legislative response. These arguments encompassed several theories. For example, some have posited that the disallowance of amortization for goodwill exacerbated the "lock-in" effect of taxing the gain on the sale of assets.[51] Moreover, the failure to allow amortization of certain intangible assets

48 The basis of certain amortizable § 197 assets should, in certain circumstances, be unaffected by adjustments that relate to unrelated factors. For example, it appears anomalous that the basis of a patent or covenant not to compete be adjusted for factors that are unrelated to their utility.

49 *See infra* notes 201-07 and accompanying text.

50 The support for legislation, on policy grounds, was not unanimous. One commentator believed the allowance of a 14 year amortization period, as provided for in the House bill, would encourage leveraged corporate takeovers by reducing the effective tax rate on these investments from 34% to a negative 18%. *See* Calvin H. Johnson, *Effective Tax Rates on High-Goodwill Takeovers Under House and Senate Bills*, 93 TAX NOTES TODAY 158-53, July 29, 1993, *available in* LEXIS, Fedtax Library, TNT file (reprinting a letter from the author to Senator Moynihan, chairman of the Senate Finance Committee). *See also* Jack Taylor, *Amortization of Customer-Based Intangibles: An Economic Perspective, reprinted in Purchase Price Allocations and Amortization of Intangibles, supra* note 13, at B-401 (arguing, in a variation of the mass asset theory, that amortization is unnecessary to properly measure income on the theory that if mere passage of time creates a customer base, such passage of time also serves to restore such base).

51 *See* Jane G. Gravelle & Jack Taylor, *Tax Neutrality and the Tax Treatment of Purchased Intangibles*, 45 NAT'L. TAX J. 77, 82 (1992). The "lock-in" effect refers to the

purportedly put domestic taxpayers at a competitive disadvantage in comparison to foreign competitors whose laws often allowed goodwill amortization.[52] Other reasons advanced included the notion that goodwill is a wasting asset and, therefore, should be amortized to correctly match revenues with expenses.[53] Against this backdrop, section 197 was enacted.

B. *Section 197—A Detailed Analysis*

1. Operative Provisions

Section 197 provides that a taxpayer is permitted an amortization deduction for any amortizable section 197 intangible.[54] The amortization deduction is determined by amortizing the adjusted basis of the section 197 intangible asset ratably over a fifteen-year period.[55] Moreover, section 197 is to be the exclusive method of cost recovery for assets subject to its provisions.[56] Property subject to section 197 is treated, for purposes of Chapter 1 of the Internal Revenue Code, as property which is of a character subject to depre-

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tendency for an investor to hold an investment longer than she otherwise would in order to avoid being taxed on the disposition of the investment.

52 *See* Kitchel, *supra* note 12. This argument appears to be based on the desire for world-wide neutrality. A foreign entity's acquisition of a United States trade or business would not place the foreign owner at a competitive advantage with respect to United States taxation because the business acquired would be subject to U.S. taxation. *See* I.R.C. §§ 871(b) (1988 & Supp. IV 1992); 881(a) (1988). An advantage may exist, however, for foreign owners of U.S. businesses who may amortize goodwill in their home country and claim unrestricted foreign tax credits against their local tax liability based on the U.S. tax paid or to foreign buyers that acquire foreign operations not subject to U.S. tax. The desire to eliminate these advantages appears to be grounded on a theory of world-wide neutrality. It is also possible that a U.S. acquirer of a foreign business may be placed at an advantage when compared to the owner of a U.S. business. If the host country allows for the amortization of goodwill and going concern value under its taxing scheme then, conceivably, the U.S. acquirer could generate additional foreign tax credits. This result might arise because the denial of amortization deductions, for U.S. purposes, will tend to lower the effective foreign tax rate on that income and possibly allow other foreign taxes that would otherwise not be available to be utilized. Many variables would need to be analyzed before determining whether this result would occur—a task well beyond the scope of this work. *See generally* I.R.C. §§ 901-05 (1988 & Supp. IV 1992).

53 *See* Kitchel, *supra* note 12. Use of the matching principle as a rationale for amortizing intangibles, however, highlights the inconsistency that exists between the treatment of purchased and self-created intangibles. Perhaps the argument for administrative convenience overcomes the violence done to the matching principle with respect to self-created intangibles. Moreover, the Supreme Court's decision in *INDOPCO* may eventually diminish the disparity between purchased and self-created intangibles. *See infra* note 71.

54 I.R.C. § 197(a) (West 1994).

55 *Id.*

56 *Id.* § 197(b).

ciation under section 167.[57] As a result, amortization deductions allowed or allowable are subject to section 1245 recapture.[58] This rule could have significant planning implications for the real estate industry and will be discussed in greater detail below.[59]

A statutory version of the mass asset rule has been enacted that prohibits the recognition of loss on the disposition of an amortizable section 197 intangible asset that was acquired in a transaction or series of transactions if any other amortizable section 197 intangibles, acquired in the same transaction or series of transactions, are retained by the taxpayer.[60] Any loss not recognized is added to the basis of the retained section 197 intangibles.[61] The impact of this rule is somewhat muted for the real estate industry because, to the extent section 197 causes a shifting of basis from depreciable real property to amortizable section 197 intangibles, this rule places these assets on the same footing as the structural components of a building.[62] A further restriction is placed on the ability to recognize a loss on the disposition of a covenant not to compete. A covenant not to compete will not be considered to have been disposed of prior to the disposition of the entire business in connection with which that covenant was created.[63] This language appears to prohibit the realization, not merely the recog-

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57 *Id.* § 197(f)(7).

58 *See id.* § 1245(a)(3) (1988 & Supp. IV 1992). The regulations make clear that intangible personal property is a § 1245 asset. Treas. Reg. § 1.1245-3(b)(2) (1971). *See also infra* note 308 and accompanying text.

59 *See infra* note 308 and accompanying text.

60 I.R.C. § 197(f)(1)(i) (West 1994).

61 *Id.* § 197(f)(1)(ii).

62 Structural components of a building are subject to a version of the mass asset rule. The cost of the structural components of a building must be recovered as a whole and not as an aggregation of constituent parts. Prop. Treas. Reg. § 1.168-2(e)(1), 49 Fed. Reg. 5940 (1984). Moreover, the retirement of a structural component is excluded from the definition of a "disposition" thereby precluding recognition of loss on the retirement of a structural component. *Id.* § 1.168-6(b)(1). This rule has proved problematic in the context of improvements made by the landlord to leased property upon termination of the lease. The proposed regulations appear to leave open the possibility that this rule will not apply in the case where the improvement in question is not a structural component of a building and in situations where the asset involved is abandoned, as opposed to retired. However, the legislative history could be read to sanction application of the mass asset rule in broader contexts. *See* Staff of Joint Committee on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981, 85 (Comm. Print 1981).

However, to the extent that a taxpayer would have been able to carve out a separate amortizable intangible asset without regard to § 197 this rule will serve to prevent the recognition of a loss that would have been recognizable under prior law.

63 I.R.C. § 197(f)(1)(B) (West 1994).

nition, of loss on the disposition of a covenant not to compete.[64] This limitation will have its greatest effect in situations where the covenant not to compete is the only section 197 intangible acquired.[65] In fact, the statutory language would appear to prevent a loss deduction in cases where the covenant is successfully challenged by the covenantor on public policy grounds or other state law grounds.[66]

2. Amortizable Section 197 Intangible Assets

Amortizable section 197 intangible assets are defined as section 197 intangible assets acquired after August 10, 1993 and held in connection with the conduct of a trade or business or an activity entered into for profit.[67] Excluded from the category of amortiza-

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64 The statutory language would appear to prevent the realization of gain on the disposition of a covenant. Although not encountered frequently, it is conceivable that a portion of a business or property could be sold and the covenant "run with the property," resulting, consequently, in a gain allocable to the covenant. *See infra* note 272.

65 This is not an uncommon occurrence. Frequently, covenants not to compete were used both as a technique to accelerate the recovery period of the assets acquired and as a stand-in for the installment sales method by a seller. However, the income generated by the covenantor is taxed as ordinary income. *See, e.g.*, Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954); Rev. Rul. 69-643, 1969-2 C.B. 10. When capital gain rates and ordinary income rates were identical or relatively close to one another, as they had been after the Tax Reform Act of 1986, this strategy created little tension between buyers and sellers of assets. However, given the reintroduction of a fairly significant capital gain rate disparity by the Omnibus Budget Reconciliation Act of 1993, *supra* note 2, it would be expected that this technique would be more difficult, or costly, to implement. Disregarding the effect of the phaseout of itemized deductions and personal exemptions, the top marginal tax rate on ordinary income is 39.6%. *See* I.R.C. § 1(a)-(e) (Supp. IV 1992). The maximum tax rate on capital gains is 28%, ignoring an elective provision not relevant here. *Id.* § 1(h).

In fact, the legislation anticipated that this rate disparity would lead to creative efforts by taxpayers to seek out capital gain income. As a result § 1258 was enacted, recharacterizing a portion of the capital gain income recognized on a "conversion transaction" as ordinary income. *See id.* § 1258(a) (1988). A "conversion transaction" is one of several enumerated transactions whereby substantially all of the expected return is attributable to the time value of money. *Id.* § 1258(c). The amount recharacterized is limited to approximate the income from a lending transaction. For an analysis of this provision see Donald J. Mason & Gary M. Choate, *The Revenue Reconciliation Act of 1993 Attacks the Conversion of Ordinary Income to Capital Gain*, 1993 TAX ADVISER 691.

66 Courts carefully scrutinize covenants not to compete and will not enforce them, as written, if they are unreasonably broad. As an alternative to voiding covenants, courts have increasingly limited a covenant's provisions to reflect what courts have considered reasonable. A variety of factors are considered, including temporal and geographic restrictions and, increasingly, the effect enforcement of the covenant has on the public. *See, e.g.*, Central Adjustment Bureau, Inc. v. Ingram, 678 S.W.2d 28 (Tenn. 1984); RESTATEMENT (SECOND) OF CONTRACTS § 184(2) (1979).

67 I.R.C. § 197(c)(1) (West 1994).

ble section 197 intangible assets are self-created intangibles,[68] other than licenses, permits, or other rights granted by a governmental unit, agency, or instrumentality; covenants not to compete entered into in connection with the acquisition of an interest in a trade or business or a substantial portion thereof; and franchises, trademarks, and tradenames.[69] However, these exclusions do not apply if the asset is created "in connection with a transaction, or series of transactions, involving the acquisition of assets constituting a trade or business or substantial portion thereof."[70]

The exception for self-created intangible assets eliminates the application of section 197 to many expenditures generated by an on-going trade or business, such as employee training, market development, institutional advertising, management-labor relations, supplier relations efforts, package design costs, and internal software development. The expenditures noted above will be subject to existing rules, including the effects of *INDOPCO, Inc. v. Commissioner.*[71] Covenants not to compete entered into as a result of an employment termination agreement will escape the application of

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68 For purposes of § 197, self-created intangibles include those intangible assets produced for the taxpayer under a contract with a third party entered into for the production of the intangible. *See* Conference Rep., *supra* note 47, at 225.

69 I.R.C. § 197(c)(2) (West 1994). The inclusion of covenants not to compete as an exception to the general rule for self-created intangible assets appears redundant. Section 197(d)(1)(E) expressly limits the application of § 197 to covenants not to compete "entered into" in connection with the acquisition of an interest in a trade or business or substantial portion thereof. The exclusion for covenants not to compete from the general rule excepting self-created intangibles from § 197 refers specifically to § 197(d)(1)(E). *Id.* § 197(c)(2)(A). The flush language of § 197(c) then provides that the exception for self-created intangibles does not apply if the asset is "created" in connection with the acquisition of a trade or business or substantial portion thereof. Presumably, a distinction may exist between "entering into" and "creating" a covenant. If the language was meant to convey that covenants entered into by a separate agreement but related to the acquisition would be covered under § 197(c), it could have been drafted more clearly.

70 *Id.* § 197(c)(2).

71 112 S. Ct. 1039 (1992). *INDOPCO* held that the existence of a separate and distinct asset is not the exclusive factor in determining whether an expenditure must be capitalized under § 263 and that the realization of a continuing long-term benefit from the expenditure is relevant to such a determination. It is unclear just how far the IRS or the courts will stretch the reasoning of *INDOPCO,* although there have been indications that the IRS will exercise a modicum of restraint in this regard. *See* Rev. Rul. 92-80, 1992-2 C.B. 57 (holding that *INDOPCO* will not affect the treatment of advertising costs as deductible business expenses under § 162).

With respect to certain self-created items, *INDOPCO* need not be a source of anxiety because existing rules are rather unpleasant. For example, package design costs must be capitalized and, unless they relate to a discrete event, such as the Olympic Games, proving a finite useful life may be difficult. However, several favorable alternatives are provided to a taxpayer with respect to these costs. *See generally* Rev. Rul. 89-23, 1989-1 C.B. 85; Rev. Proc. 90-63, 1990-2 C.B. 664; Rev. Proc. 89-17, 1989-1 C.B.

section 197 if the employee owns no interest in the entity or assets redeemed in connection with the entering into of the covenant.

3. Section 197 Intangible Assets

Only section 197 intangible assets qualify for amortization under section 197(a). Intangible assets may be grouped into one of three categories. First, certain intangible assets are always governed by section 197. Second, other intangible assets are subject to section 197 only if acquired in connection with the acquisition of an interest in, or the assets of, a trade or business or a substantial portion thereof. Lastly, certain intangible assets are categorically excluded from section 197.

a. *Assets Always Governed by Section 197*

The following assets are, in all circumstances, section 197 assets:

1. Goodwill[72] and going concern value.[73] As a practical matter, these assets will typically be acquired only in the context of a transaction encompassing the acquisition of a trade or business. However, the ability to amortize these assets in all cases provides some comfort in the event *INDOPCO* is used aggressively by the IRS to require capitalization of costs heretofore expensed.[74] Conceptually, the difficulty lies in determining just what is left to be placed in these two categories of assets after considering the statutory definition given to other section 197 assets—an issue that is discussed subsequently in this work.[75]

2. Workforce in place. This asset includes both the value of contractual provisions in place and compositional elements, such as skill, education, age, and similar factors.[76] The statutory language appears broad enough to include the value attendant to compositional elements that may prevent, or limit, legal claims against the employer. For example, an effective human resource program that monitors compliance with the Americans with Disabilities Act of 1990,[77] the Age Discrimination in Employment Act,[78]

827; Rev. Proc. 89-16, 1989-1 C.B. 822 (providing general guidance and allowing elective 60 month and 48 month amortization periods under certain circumstances).

72 I.R.C. § 197(d)(1)(A) (West 1994).

73 *Id.* § 197(d)(1)(B).

74 *See supra* note 71.

75 *See infra* notes 187-200 and accompanying text.

76 I.R.C. § 197(d)(1)(C)(i) (West 1994).

77 42 U.S.C. §§ 12101-213 (Supp. IV 1992).

78 29 U.S.C. §§ 621-34 (1988 & Supp. IV 1992).

and Title VII of the Civil Rights Act of 1964,[79] resulting in a workforce with broad representation from discrete groups, should increase the value of this asset.[80] Moreover, the legislative history indicates that this asset may encompass independent contractors, as well as employees.[81]

3. Business books and records, operating systems, and any other information base.[82] The statute expressly includes lists of current and prospective customers in this category of intangibles.[83] Other assets that may be included here include training and technical manuals, accounting control systems, and data files.[84]

4. Formulas, processes, designs, know-how, format, and similar items.[85] Included in this category are package designs and computer software other than off-the-shelf software.[86] Patents, copyrights, films, recordings, video tapes, books, and similar property are included in this category only if acquired as part of the acquisition of assets constituting a trade or business or substantial portion thereof.[87] The relationship between these assets and workforce in place is not entirely clear. For example, know-how is typically a valuable attribute in a workforce. It appears that this category captures those items representing knowledge that is either recorded in some discrete form or has obtained a distinct legal status.

5. Customer-based intangibles.[88] This category is defined to

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79 42 U.S.C. §§ 2000e-2000e-17 (1988 & Supp. IV 1992).

80 It is also conceivable that value may be assigned to compositional elements that tend to reduce an employer's expenditures with respect to employee benefit plans. The variables that should be analyzed would depend on the type of plan in question, and actuarial assumptions would play a dominant role in the valuation. However, a benchmark workforce composition would need to be created. To determine whether cost savings are present, the workforce must be measured against a model workforce that would otherwise have been used. Typically, the cost of benefits is taken into account in determining the overall cost of the workforce which, in turn, enters into the valuation of the asset. However, it is unclear whether this cost is analyzed as fully as it should be, particularly where taxable salaries or wages are set without much attention to the fringe benefits provided.

81 Conference Rep., *supra* note 47, at 213. It would appear that the value of relationships with independent contractors would also qualify as a supplier-based intangible. The inclusion of such relationships within this category subjects them to § 197 in all cases and will not require the predicate act of acquiring a trade or business or a substantial portion thereof. *See infra* notes 126-28 and accompanying text.

82 I.R.C. § 197(d)(1)(C)(ii).

83 *Id.*

84 Conference Rep., *supra* note 47, at 213-14.

85 I.R.C. § 197(d)(1)(C)(iii).

86 Conference Rep., *supra* note 47, at 214.

87 *See infra* note 123 and accompanying text.

88 I.R.C. § 197(d)(1)(C)(iv).

include market composition, market share, and any other value resulting from the future provision of goods and services in the ordinary course of business.[89] In the case of a financial institution, deposit base and similar items are included within this category.[90] The acquisition of accounts receivable or similar rights arising from goods or services already provided to customers are excluded from section 197.[91]

6. Supplier-based intangibles.[92] This category comprises any value resulting from the future acquisition of goods or services pursuant to relationships, whether contractual or otherwise, "in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer."[93] However, the scope of this provision has been significantly curtailed by section 197(e)(4)(B).[94]

7. Licenses, permits, or other rights granted by a governmental unit, agency, or instrumentality.[95] Liquor licenses, broadcast licenses, airport landing slots, and taxi-cab medallions are examples of the types of licenses or rights included herein.[96] Moreover, the fact that a right or license may be renewed indefinitely is irrelevant to its classification as a section 197 asset.[97] However, rights that represent interests in land are excluded from this category.[98]

8. Any trademark, franchise, or trade name.[99] A franchise is any agreement that provides one of the parties to the agreement "the right to distribute, sell, or provide goods, services, or facilities within a specified area."[100] Costs incurred in renewing a franchise, trademark, or trade name are treated as acquisitions of the asset renewed.[101] However, amounts subject to section 1253(d)(1) are

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89 *Id.* § 197(d)(2)(A).

90 *Id.* § 197(d)(2)(B).

91 These assets would be allocated a portion of the purchase price as a Class III asset pursuant to § 1060. *See supra* note 38 and accompanying text.

92 I.R.C. § 197(d)(1)(C)(v).

93 *Id.* § 197(d)(3).

94 *See infra* note 126 and accompanying text.

95 I.R.C. § 197(d)(1)(D).

96 Conference Rep., *supra* note 47, at 215.

97 *Id.*

98 For example, mineral rights, grazing rights, timber rights, and zoning variances are excluded from § 197. Conference Rep., *supra* note 47, at 219. Moreover, the cost of obtaining building permits and similar rights or licenses are includable in the cost of the improvements to which the rights or licenses relate. *Id.*; *see also infra* note 267 and accompanying text.

99 I.R.C. § 197(d)(1)(F).

100 *Id.* § 1253(b)(1) (1988). This definition is adopted for purposes of § 197. *See* Conference Rep., *supra* note 47, at 216-17.

101 I.R.C. 197(f)(4)(B).

excluded from the application of section 197.[102] These are amounts paid for a franchise, trademark, or trade name that are contingent on the productivity, use, or disposition of the asset in question and payable at least annually in substantially identical amounts or pursuant to fixed formulas.[103] These payments continue to be deductible currently.

b. *Assets Acquired in Connection with the Acquisition of a Trade or Business*

Certain intangible assets, in order to come under the operative provisions of section 197, must be acquired in connection with a transaction involving the acquisition of an interest in, or the assets of, a trade or business or substantial portion thereof. The statute does not describe when, or under what circumstances, an acquisition of assets will result in the acquisition of a trade or business or a substantial portion thereof. The legislative history, however, provides guidance.

A group of assets will constitute a trade or business, for purposes of section 197, if the use of such assets would constitute a trade or business under section 1060.[104] The regulations under section 1060 provide that assets will constitute a trade or business in one of two circumstances. First, a group of assets will constitute a trade or business for purposes of section 1060 if the use of such assets would constitute an active trade or business for purposes of section 355.[105]

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102 *Id.* § 197(f)(4)(C). However, the existence of these assets may result in the classification of a group of assets as a trade or business, thereby causing § 197 to apply to certain assets otherwise excluded from the application of § 197. *See infra* note 104 and accompanying text.

103 *Id.* § 1253(d)(1). For a thorough analysis of § 1253 see Franklin L. Green, *Section 1253 Revisited: A Case Study Of Modern Reform*, 92 TAX NOTES TODAY 184-89, Sept. 10, 1992, *available in* LEXIS, Fedtax Library, TNT file. *See also Transfers of Franchises, Trademarks, and Trade Names - Section 1253*, 304-2d Tax Mgmt. (BNA).

104 Conference Rep., *supra* note 47, at 218. The report also states that the Treasury Department will, pursuant to regulations to be issued under § 197, include the acquisition of a single intangible asset within the definition of a substantial portion of a trade or business in appropriate circumstances. *Id.* at 217. The report goes on to state that the acquisition of franchises, trademarks, or trade names will constitute the acquisition of a trade or business or a substantial portion thereof. *Id.* at 218. In the case of franchises, trademarks, and trade names, this language is not necessary in order to subject these assets to § 197. However, this provision will automatically require a broad analysis of § 197 in the event other assets are acquired in connection with the acquisition of a franchise, trademark, or trade name. Moreover, it appears that this result will occur regardless of whether the latter assets are subject to § 197 or are excluded from § 197 because they are subject to § 1253(d)(1).

105 Temp. Treas. Reg. § 1.1060-1T(b)(2) (1988).

Determination of whether a group of assets constitutes a substantial portion of a trade or business will be based upon all the facts and circumstances, including the nature and amount of assets acquired and those retained by the transferor.[106] The proportionate value of the assets acquired relative to the value of the assets retained by the seller will not be determinative.[107]

Before analyzing the requirements for a trade or business classification under section 355, it is important to determine at the outset to whom this requirement is to be applied. Section 1060 is applicable if the assets comprise a trade or business to either the buyer or the seller.[108] It is arguable that the trade or business requirement of section 197 should not apply in cases where the assets acquired do not comprise a trade or business, or substantial portion thereof, to the seller.[109]

The regulations under section 355 define a trade or business as "a specific group of activities . . . carried on for the purpose of earning income or profit, and the activities include[ ] . . . every operation that forms a part of, or a step in, the process of earning or profit."[110] In order for a taxpayer to actively conduct the trade or business, the taxpayer must generally perform substantial management and operational functions.[111] These functions must be substantially performed by the taxpayer directly and not by independent contractors.[112] The ownership and operation, including leasing, of real or personal property will not constitute the active conduct of a trade or business unless the owner renders "significant services with respect to the operation and management of the property."[113] The regulations contain an example that

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106 *Id.*

107 *Id.*

108 *Id.* § 1.1060-1T(b)(1).

109 The application of § 1060 in cases where the assets do not constitute a trade or business in the hands of the seller has been criticized as overly broad. For example, the acquisition of assets pursuant to a turn-key contract will subject the buyer to § 1060 even though the transaction lacks any potential for the acquisition of goodwill or going concern value. *See ABA Tax Section Members Offer Suggestions on the Allocation Rules for Asset Acquisitions*, 89 TAX NOTES TODAY 75-27, April 5, 1989, *available in* LEXIS, Fedtax Library, TNT file (reporting the comments of several committees of the ABA Tax Section on the proposed and temporary regulations under § 1060). Moreover, as a technical matter, Temporary Treasury Regulation § 1.1060-1T(b)(1) defines an "applicable asset acquisition." The trade or business definition is put forth in § 1.1060-1T(b)(2). The latter provision makes no reference to whom the test should be applied.

110 Treas. Reg. § 1.355-3(b)(2)(ii) (as amended in 1989).

111 *Id.* § 1.355-3(b)(2)(iii) (1989).

112 *Id. See also* Rev. Rul. 73-236, 1973-1 C.B. 183; Rev. Rul. 73-237, 1973-1 C.B. 185.

113 Treas. Reg. § 1.355-3(b)(2)(iv)(B) (as amended in 1989).

makes clear that the active trade or business requirement is met if the owner manages the property, seeks new tenants, keeps up the property, and negotiates leases.[114]

It is common in the retail real estate industry for the management of the properties to be performed by a separate management company under contract. In the case where a management company performs most, if not all, of the leasing, maintenance, and marketing work then the active trade or business requirement may not be met.[115]

An alternative method of satisfying the section 1060 trade or business requirement is to acquire a group of assets to which goodwill or going concern value could attach under any circumstances.[116] This alternative method will encompass situations that would fail the section 355 definition of an active trade or business because the taxpayer was performing the required activities through an agent. It will also encompass asset acquisitions that fail to qualify as a trade or business, whether active or otherwise, under section 355. Note that this test requires that goodwill and going concern value possibly arise. Therefore, to the extent that assets, heretofore considered part of goodwill or going concern value, are carved out and separately classified, this test may no longer be as easy to satisfy.[117]

The statute contains two types of predicate transactions required to satisfy the trade or business requirement. The broader of the two types of transactions is reserved exclusively for application to covenants not to compete. All other assets subject to the trade

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114 Treas. Reg. § 1.355-3(c), example (12) (as amended in 1989). The general applicability of § 1060 to rental real estate has been criticized on the grounds that most rental real estate does not involve goodwill or going concern value. Therefore, subjecting the acquisitions of these properties to § 1060 will result in needless compliance costs. *See Los Angeles County Bar Members Say Asset Allocation Rules Should Not Be Applied To Sales of Rental Real Property*, 88 TAX NOTES TODAY 236-25, Nov. 23, 1988, *available in* LEXIS, Fedtax Library, TNT file; *ABA Tax Section Members Offer Suggestions on the Allocation Rules for Asset Acquisition*, *supra* note 109, at 16.

115 To whom the trade or business requirement applies may be of critical importance in this situation. For example, if the seller used an outside management company and the trade or business requirement applies solely to the seller, the trade or business requirement would not be met. This anomalous result could lead one to the conclusion that the seller's status alone should not be determinative of whether an active trade or business exists. However, the second prong of the trade or business test under § 1060 will rectify problems of this sort. *See infra* note 116 and accompanying text.

116 Temp. Treas. Reg. § 1.1060-1T(b)(2) (1988).

117 *See infra* note 201-07 and accompanying text.

or business requirement are governed by the alternative form of transaction described in the statute.

In order for section 197 to apply to a covenant not to compete, the covenant must be created or entered into in connection with the acquisition of "an interest in" a trade or business or substantial portion thereof.[118] An interest in a trade or business will include, in addition to the purchase of assets, a purchase of stock or partnership interest.[119] For purposes of section 197, arrangements having the effect of a covenant not to compete will be treated as covenants. For example, consulting payments to former owners in excess of reasonable compensation for services will be treated as a covenant not to compete.[120] The desirability of using covenants not to compete, from a tax standpoint, has been substantially diminished. The combination of a fifteen-year recovery period for the covenant, ordinary income to the covenantor, and rapid write-offs for financial accounting purposes will force a reevaluation of the use of such covenants.[121]

In order to qualify under section 197, certain assets must be acquired in connection with the "acquisition of assets constituting a trade or business or substantial portion thereof."[122] The following assets are subject to this requirement:

1. Interests in a film, sound recording, video tape, book, or similar assets.[123] These assets fall within the category of section 197 intangibles that include formulas, processes, designs, know-how, and similar items.[124] If these items fail to qualify as section 197 intangibles their cost is generally recoverable through depreciation pursuant to section 167.[125]

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118 I.R.C. § 197(d)(1)(E) (West 1994).

119 Conference Rep., *supra* note 47, at 216.

120 *Id.*

121 For a detailed analysis of the expected effect § 197 will have on the use of covenants not to compete see William L. Raby, *Sales of Closely Held Businesses: Does the New Tax Law Eliminate Allocation Games*, 93 TAX NOTES TODAY 225-54, Nov. 2, 1993, *available in* LEXIS, Fedtax Library, TNT file.

122 I.R.C. § 197(e)(4). A stock acquisition, coupled with a § 338 election, would qualify under this provision. *See supra* note 7.

123 I.R.C. § 197(e)(4)(A).

124 *See supra* text accompanying note 87.

125 These items are not eligible for cost recovery under the Modified Accelerated Cost Recovery System. I.R.C. § 168(f)(3)-(4) (1988). Moreover, they must be depreciated over their estimated useful life under the straight-line or income forecast methods. *See Purchase Price Allocations and Amortization of Intangibles*, *supra* note 13, at A-44 n.402.1 (providing the somewhat tortured method of obtaining the legislative support for this rule). These assets are, however, subject to the uniform capitalization rules of § 263A despite their treatment as intangible assets under the depreciation provisions. *See* I.R.C. § 263A(b) (1988).

2. Any right to acquire tangible property or services under a contract or by government grant.[126] This rule eviscerates, to a great extent, the inclusiveness of supplier-based intangibles. Supplier-based intangibles that will be subject to section 197 in the absence of a related acquisition of assets constituting a trade or business will be limited to those assets whose value rests upon informal relationships,[127] as opposed to contractual rights, and those related to the provision of intangible property. The acquisition of rights that are excluded from section 197 by this provision will be amortizable in accordance with regulations to be promulgated by the Treasury Department. The amount and method of amortization will, most likely, be affected by whether the rights are of fixed duration, for a fixed quantity, and their renewal terms.[128]

3. Any interest in a copyright or patent.[129] Under pre-section 197 law, patents and copyrights are amortizable over the shorter of their legal or useful life.[130] If the purchase of a patent or copyright fails to qualify for section 197 treatment then, presumably, existing law will apply.[131]

4. Contractual or governmentally granted rights of a fixed duration of less than fifteen years, or of fixed amount subject to recovery under a units-of-production method to the extent provided by regulations.[132] The legislative history anticipates that the opportunity to renew the rights in question through competitive bidding or similar processes will not be taken into account in determining whether the right is of fixed duration.[133] Moreover, the regulations to be issued will specify the effect renewal options have on the determination of whether rights are of fixed duration or for

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126 I.R.C. § 197(e)(4)(B) (West 1994).

127 Arguably, value associated with on-going contractual negotiations will continue to be subject to § 197 because no contractual rights will have come into existence. However, it is possible that promissory estoppel and other theories could apply and change this result. Similar issues arise in the context of the "binding contract" election out of § 197. *See infra* note 164 and accompanying text.

128 Conference Rep., *supra* note 47, at 220-21.

129 I.R.C. § 197(e)(4)(C).

130 Treas. Reg. §§ 1.167(a)-1(b) (as amended in 1972); 1.167(a)-3 (as amended in 1960). The income forecast method is often used to determine periodic amortization deductions. *See* Rev. Rul. 79-285, 1979-2 C.B. 91; Priv. Ltr. Rul. 85-010-06 (Sept. 24, 1984). Annual payments made to acquire a patent that are contingent on the productivity of the patent are, in effect, deductible when paid. *See* Associated Patentees, Inc. v. Commissioner, 4 T.C. 979 (1945).

131 The legislative history anticipates that the rule of *Associated Patentees* will continue to apply. Conference Rep., *supra* note 47, at 221. However, the report makes no reference to existing law in general.

132 I.R.C. § 197(e)(4)(D).

133 Conference Rep., *supra* note 47, at 224.

fixed amounts.[134]

5. Computer software, other than software that is available to the general public under a nonexclusive license and that has not been substantially modified.[135] The latter type of software is categorically excluded from the application of section 197.[136] The cost of amortizable computer software not subject to section 197 is amortizable on a straight-line basis over thirty-six months.[137] Existing law is to apply to software that is bundled with related hardware.[138] Moreover, the treatment of software costs that are currently expensed has not been disturbed.[139]

6. Mortgage servicing rights for residential mortgages.[140] Mortgage servicing rights for residential mortgages not subject to section 197 will be depreciable using a straight line method over a period of 108 months.[141]

c. *Assets Excluded from Section 197*

Several types of intangible assets are excluded from the definition of section 197 intangible assets. In addition, with certain exceptions, self-created intangible assets are not subject to section 197.[142] The assets that are categorically excluded from the application of section 197 are listed below.

1. Certain financial interests. Interests in a corporation, trust, partnership, or estate are not subject to section 197.[143] Moreover, any interest in existing futures, foreign currency, notional principal, or similar financial contracts are excluded from section 197.[144] However, the language limiting the exclusion to "existing" financial contracts of the type described above allows value associated with prospective contracts to qualify for general customer-

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134 *Id.*

135 I.R.C. § 197(e)(3)(A).

136 *See infra* note 150 and accompanying text.

137 I.R.C. § 167(f)(1) (West 1994).

138 Conference Rep., *supra* note 47, at 220. The cost of bundled software is depreciable as part of the related hardware. *See* Rev. Rul. 71-177, 1977-1 C.B. 5; Rev. Proc. 69-21, 1969-2 C.B. 303.

139 Conference Rep., *supra* note 47, at 220. The cost of internally developed computer software may qualify as research and experimental expenditures under § 174. For a discussion of the treatment of internally developed software see *Purchase Price Allocations and Amortization of Intangibles, supra* note 13, at A-32-33.

140 I.R.C. § 197(e)(7).

141 I.R.C. § 167(f)(3) (West 1994).

142 *See supra* notes 68-69 and accompanying text.

143 I.R.C. § 197(e)(1)(A).

144 *Id.* § 197(e)(1)(B).

based or supplier-based intangible treatment.[145]

2. Interests in land. Excluded from the definition of a section 197 intangible asset is any interest in land.[146] Interests in land include life estates, remainders, easements, mineral rights, grazing rights, riparian and air rights, and zoning variances.[147] Presumably, this exclusion would also include the lessee's interest under a ground lease or sublease.[148] However, it appears that restrictive covenants or equitable servitudes will not be categorically excluded from section 197.[149]

3. Off-the-shelf computer software. Computer software which is readily available for purchase by the general public, subject to a nonexclusive license, and that has not been substantially modified, is excluded from the definition of section 197 intangible assets.[150] The Omnibus Budget Reconciliation Act of 1993 added new section 167(f), providing for thirty-six month straight line depreciation for software excluded from the application of section 197.[151]

4. Leasehold interests. Any interests in an existing lease of tangible property is excluded from the definition of a section 197 intangible.[152] Moreover, subleases are treated as a lease of the underlying property.[153] Consequently, the acquisitions of leasehold interests will be governed by other provisions. One aspect relating to the tax accounting of lease acquisitions has been clarified by the 1993 legislation. With respect to the acquisition of property subject to a lease, section 167(c)(2) has been added to require that

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145 This treatment, of course, presumes that the subject matter of these types of contracts are considered services.

146 *Id.* § 197(e)(2).

147 Conference Rep., *supra* note 47, at 219.

148 For purposes of § 197, subleases are treated the same way as a lease of the subject property. I.R.C. § 197(f)(6). Moreover, § 197(e)(5) would also apply to exclude ground leases from the application of § 197. *See infra* note 152 and accompanying text.

149 At common law restrictive covenants and equitable servitudes were not "interests in land." Covenants were contractual rights that arose from the courts' reluctance to enforce negative easements. Equitable servitudes are, in essence, covenants enforceable in equity. Generally, the privity requirements applicable to equitable servitudes are relaxed in comparison to those applicable to covenants, but otherwise the only distinction between the two are the remedies available. *But see infra* note 259. For a brief overview of these property rights see JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 890-99 (2d ed. 1988).

150 I.R.C. § 197(e)(3)(A)(i).

151 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,261(b)(1), 107 Stat. 312, 538 (1993).

152 I.R.C. § 197(e)(5)(A).

153 *Id.* § 197(f)(6).

the entire purchase price be allocated to the property, thereby prohibiting any allocation of basis to the leasehold interest.[154] This provision codifies well-established judicial doctrines with respect to the acquisition of property subject to a lease.[155]

Section 167(c)(2), however, will not apply to situations where the landlord or sublessor incurs costs to acquire a lease unrelated to the acquisition of property. In that case, the landlord or sublessor would amortize the cost of acquiring the lease over the term of the lease.[156]

A lessee acquiring a lease will continue to be subject to section

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154 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,261(b)(2), 107 Stat. 312, 538 (1993). The language of the statute is broad enough to apply to a purchaser of a leasehold interest subject to a sub-lease. This rule is generally effective for property acquired after August 10, 1993.

155 Taxpayers have attempted to allocate a portion of the purchase price of property subject to a lease to the value of future lease payments or to the portion of the purchase price allocable to premium leases—those generating rental income at above market rates. These attempts have proved unsuccessful. *See* Ronald A. Morris & Peter A. Glicklich, *Some Incongruities in the Taxation of Leased Real Property*, 40 TAX LAW. 85, 94-106 (1986) (collecting and analyzing cases dealing with this issue). *See also Real Estate Leases and Improvements*, 47-5th Tax Mgmt. (BNA) at A-14.

A related issue is whether the acquirer of land may allocate a portion of the purchase price to the value of improvements made by the lessee that will revert to the lessor upon termination of the lease. Here also, taxpayers have generally been unsuccessful. *See* Morris & Glicklich, *supra*, at 94-95. It is unclear how § 167(c)(2) affects this issue. If the value of the improvements made by the lessee are considered to be part of the acquirer's interest in the lease § 167(c)(2) will apply. If the improvements are considered separate and distinct from the lease, arguably § 167(c)(2) does not apply. The better answer appears to be that § 167(c)(2) applies because the value of the lessee's improvements is part of the acquirer's reversionary interest in the lease.

156 Treas. Reg. § 1.162-11(a) (as amended in 1960). The regulations refer to § 178 for determining the effect of renewal options on the period over which the costs to acquire the lease are to be amortized. A related issue that often arises is tenant allowances paid by the landlord in order to fund improvements on a tenant's premises. Landlord tenant allowances, or build-out payments, may be considered a lease acquisition cost in the event that the improvements are owned by the tenant. But if the landlord owns the improvements, the cost of the improvements would be depreciable under § 168. The term of the lease would become irrelevant. *See* I.R.C. § 168(i)(8) (1988). Moreover, the ability to write-off the undepreciated basis in the improvements upon termination of the lease is questionable. *See supra* note 62.

The analysis of this issue can, however, become quite muddled. For example, if the improvement is made to the tenant's specifications, has little value in an alternative use, and the tenant manages the acquisition process then, arguably, the landlord's acquisition of the property is, in substance, merely a proxy for a cash inducement to the tenant. Prudent landlords will insist on some controls over the use of inducement funds but they should not be penalized for doing so. Moreover, title has never been the sole criteria for determining the true owner of property for tax purposes. *See* Frank Lyon Co. v. United States, 435 U.S. 561 (1978) (holding that the owner of a property, for federal income tax purposes, is to be determined by the substance and not the form of a transaction). For a discussion of the effect of this issue on structuring lease agreements see Michael Dalessio & Martin Shenkman, *Im-*

178, which requires that the lessee amortize the cost of acquiring a lease over the term of the lease. For this purpose, the lease term will include renewal options if less than seventy-five percent of the cost of acquiring the lease is assigned to the original term of the lease.[157]

5. Interests in existing indebtedness.[158] This exception applies to both debtors and creditors and precludes the application of section 197 to the value attributable to the assumption of, or the purchasing of property subject to, a below market rate loan. Generally, the premium associated with the ability to obtain below market financing is allocated to the assets purchased.[159] This could be advantageous to purchasers who assume favorable financing because it offers the possibility that the value inherent in the below market rate financing will be amortized over fifteen years as opposed to over the term of the debt.[160] This exclusion does not include deposit-based intangibles acquired by financial institutions. These items are included as part of customer-based intangibles.[161]

Additional exclusions are provided for the acquisition of sports franchises and any assets acquired in connection with such

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provements to Leased Property: Maximizing the Tax Benefits Regardless of Who Makes Them, 33 TAX. ACCT. 256 (1984).

157 I.R.C. § 178(a). The regulations provide that this determination is to be made based on all the facts and circumstances applicable. In certain cases the determination may be made by resorting to present value principles. This would entail determining the present value of a $1 annuity for the original term of the lease and comparing it to the present value of a $1 annuity for the entire term of the lease, including renewal periods. Use of the present value method, as the regulations imply, would not be appropriate in the case that rental rates are to be adjusted at renewal. *See* Treas. Reg. § 1.178-1(b)(5) (1960).

158 I.R.C. § 197(e)(5)(B) (West 1994).

159 The original issue discount rules do not apply to debt assumptions provided that the debt is not modified as that term is defined pursuant to § 1001. *See* Prop. Treas. Reg. § 1.1274-7, 51 Fed. Reg. 12,022, 12,081 (1986). The determination of whether a debt has been modified is an issue unto itself and has been muddled by the recent Supreme Court decision in *Cottage Savings Association. v. Commissioner*, 111 S. Ct. 1503 (1991). *See* Richard H. Nicholls, Cottage Savings: *More S & L Problems?*, 45 TAX LAW. 727 (1992) (discussing the effect of *Cottage Savings* on debt modifications in general and debt assumptions in particular).

160 Because amortizable § 197 assets will take the residual allocation pursuant to § 1060, it is possible that any additional consideration paid due to the favorable financing will find its way to § 197 assets. *See supra* note 45 and accompanying text. If the remaining term of the debt exceeds 15 years, this result will accelerate the recovery of the additional cost to acquire the property. Moreover, cost recovery will be further accelerated because it will be calculated on a straight-line method as opposed to the effective interest rate method. The consequences are reversed, however, if the additional cost is allocable to nondepreciable land or real property recoverable over 39 years.

161 *See supra* note 90 and accompanying text.

franchises.[162] Moreover, transaction costs and professional fees incurred in a corporate organization or reorganization are excluded from section 197 if any portion of the gain or loss on the transaction is not recognized.[163]

d. *Effective Dates and Anti-churning Rules*

In general, section 197 applies to intangible assets acquired after August 10, 1993. However, a taxpayer may elect not to apply section 197 for intangible assets acquired after August 10, 1993, if those assets were acquired pursuant to a written binding contract in effect on August 10, 1993, and at all times thereafter up to the time of the acquisition.[164] The election will apply to all property acquired pursuant to the contract for which the election applies and is revocable only with the consent of the IRS.[165] Because this election is applicable to individual contracts, the taxpayer is offered a planning opportunity in the event multiple acquisitions were pending on August 10, 1993. The statute allows the taxpayer to elect section 197 for acquisitions with large goodwill or going concern components and forego the election in cases where pre-section 197 law allows a more rapid recovery of the intangible in question.[166]

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162 I.R.C. § 197(e)(6).

163 *Id.* § 197(e)(8).

164 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,261(g)(3)(A), 107 Stat. 312, 540 (1993). Temporary and proposed regulations were recently issued that provide guidance on the manner of making the election. The election must be made by the due date, including extensions of time, of the taxpayer's income tax return for the tax year that includes August 10, 1993. However, if that return is filed before April 14, 1994, then the election may be made on a return filed no later than September 12, 1994. Temp. Treas. Reg. § 1.197-1T(d)(2)(i), 59 Fed. Reg. 11,925 (1994). A letter of intent may qualify as a written binding contract provided it constitutes a legal obligation of the buyer under state law. Moreover, contingencies placed upon closing should not disqualify the agreement, provided they are not under the buyer's control or, if they are under the buyer's control, state law imposes restrictions upon the buyer's discretion, such as a duty to act in good faith or to act reasonably. *See* Jack S. Levin & Donald E. Rocap, *A Transactional Guide To New Section 197*, 93 TAX NOTES TODAY 224-86, Nov. 1, 1993, *available in* LEXIS, Fedtax Library, TNT file. Although a duty of good faith is imposed in the performance of a contract, such a duty will not necessarily exist during the negotiation process. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979). However, it is possible that a court will view the parties' relationship during negotiations as contractual. *See* Channel Home Centers v. Grossman, 795 F.2d 291 (3d Cir. 1986).

165 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,261(g)(3)(B), 107 Stat. 312, 540 (1993).

166 The statute expressly refers to "property acquired pursuant to the contract" as the subject matter of the election. *Id.* § 13,261(g)(3)(B)(ii). It is arguable, therefore, in the case of an acquisition effectuated through the use of multiple contracts, that the election may be made for some of the contracts and not others. For example, an

A second elective provision gives the effect of applying section 197 as if it were effective for intangible asset acquisitions after July 25, 1991.[167] The election, once made, is revocable only with the consent of the IRS, and applies to all taxpayers under common control with the electing taxpayer.[168] Moreover, this election precludes the use of the election, discussed above, to exclude assets acquired pursuant to a binding contract in effect on August 10, 1993.[169]

Unlike the election to exclude assets from the application of section 197, this election will apply to all assets acquired after July 25, 1991, and cannot, therefore, be used selectively. Taxpayers should examine the mix of intangible assets acquired and determine whether the application of section 197 is beneficial or not. In many cases this will not be as straight forward as it would appear. For example, potential dispositions must be considered. The detrimental effect of the loss disallowance rule of section 197(f)(1) may outweigh the benefits of increased amortization deductions.

In addition to the two elective provisions discussed above, a detailed set of anti-churning rules are provided to prevent intangible assets from qualifying as section 197 intangibles. The anti-churning rules apply to goodwill, going concern value, and assets that, but for the enactment of section 197, would not have been

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acquisition may include separate contracts for covenants not to compete or technology transfers. It would be of tremendous advantage for a taxpayer to be able to elect out of § 197 for assets that have a relatively short useful life, under pre-section 197 law, while utilizing § 197 for the goodwill or going concern components of the acquisition. However, if one of the acquisition agreements serves as the central agreement and refers to, incorporates, or is conditional upon, the other agreements, the IRS could assert that all assets were acquired pursuant to one contract. Moreover, if a letter of intent could qualify as a binding contract the letter of intent may very well subsume all related agreements. *See supra* note 164. Recently issued temporary and proposed regulations provide that this election applies separately to each eligible "acquisition." It is not clear whether the regulations take the position that all contracts incident to effectuating an acquisition are to be treated as one contract for purposes of making this election or merely assumed that each acquisition would be consummated through one contract. *See* Temp. Treas. Reg. § 1.97-1T(d)(1)(i), 59 Fed. Reg. 11,925 (1994).

167 Omnibus Budget Reconciliation Act of 1993, § 13,261(g)(2)(A). The election must be made by the due date, including extensions of time, of the taxpayer's income tax return for the tax year that includes August 10, 1993. However, if that return is filed before April 14, 1994, then the election may be made on an amended return filed no later than September 12, 1994. Temp. Treas. Reg. § 1.197-1T(c)(3)(i), 59 Fed. Reg. 11,923 (1994).

168 *Id.* § 13,261(g)(2)(B). Whether taxpayers are under common control is determined by applying the rules of § 41(f)(1)(A)-(B). *Id.* § 13,261(g)(2)(B)(ii).

169 *Id.* § 13,261(g)(3)(A).

amortizable.[170] This rule will continue to lead to disputes over whether an asset has an ascertainable useful life or is separable from goodwill. Moreover, the anti-churning rules are not limited to the value of the intangible at August 10, 1993 but apply to the entire cost of acquisition.

The anti-churning rules apply in three circumstances.[171] First, an asset will not be considered an amortizable section 197 intangible asset if the asset was held or used at any time after July 25, 1991, and on or before August 10, 1993,[172] by the taxpayer or a related person.[173] A related person is defined by reference to sections 267(b), 707(b)(1), and 41(f)(1)(A)-(B), and there is significant overlap in these provisions so that persons may be related under more than one of these sections. For purposes of applying this rule, sections 267(b) and 707(b)(1) are applied by substituting twenty percent for fifty percent.[174] Relatedness is determined immediately preceding or immediately following the acquisition of the intangible.[175]

Second, the anti-churning rules will apply to an intangible asset acquired from a person who held such intangible at any time between July 25, 1991, and August 10, 1993,[176] and, as part of the transaction, the user of the property does not change.[177] Whether the user of the property changes is to be determined pursuant to regulations issued by the Secretary.[178] The statute includes no reference to related persons in determining whether the user of the property changes but, in all likelihood, the regulations will incorporate a related person rule. The anti-churning rules will have serious consequences in the case of intangibles licensed to a taxpayer

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170 I.R.C. § 197(f)(9)(A) (West 1994).

171 In the case of partnership property, the anti-churning rules will apply to any increases in the basis of partnership property pursuant to §§ 732, 734, and 743. The rules will apply at the partner level and each partner is treated as having owned or used such partner's proportionate share of the partnership's assets. *Id.* § 197(f)(9)(E).

172 If the election to apply § 197 to assets acquired after July 25, 1991, is made only the holding or using of the property on July 25, 1991, is considered in applying the anti-churning rules. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,261(g)(2)(A)(iii), 107 Stat. 312, 540 (1993).

173 I.R.C. § 197(f)(9)(A)(i).

174 *Id.* § 197(f)(9)(C). If the anti-churning rules apply as a result of this reduction an elective provision may provide relief. *See infra* note 181 and accompanying text.

175 *Id.*

176 If an election is made to apply § 197 to assets acquired after July 25, 1991, the date upon which to examine the holding of the property is limited to July 25, 1993. *See supra* note 167 and accompanying text.

177 I.R.C. § 197(f)(9)(A)(ii).

178 *Id.* § 197(f)(9)(A).

with an option to purchase. This is a fairly common transaction in the case of trademarks and technology. In the event the option is exercised, these rules will prevent the buyer from amortizing the asset pursuant to section 197.[179]

Last, the anti-churning rules prevent section 197 from applying to an intangible asset acquired by the taxpayer who "grants the right to use the intangible to a person (or a party related to a person) who held or used such property at any time" between July 25, 1991, and August 10, 1993.[180] This rule is intended to prevent the sale and license-back of an intangible asset in order to allow the buyer to amortize the asset while presumably sharing the tax benefits with the seller through the setting of royalty rates.

Exceptions to the anti-churning rules apply in the case of certain related party acquisitions where the selling party recognizes gain on the transfer of the intangible and elects to pay tax at the highest rate applicable to such person.[181] This exception applies only in the case where the anti-churning rules apply because of the reduction in the 267(b) and 707(b)(1) percentage relationship tests to twenty percent from fifty percent.[182] If the election is made, the anti-churning rules apply only to the extent that the basis of the acquired intangible exceeds the gain recognized.[183] This provision will be beneficial to the extent that the increased tax to the seller, as a result of this election, is outweighed by the present value of increased amortization deductions to the buyer.[184] Of course, the seller would, or should, insist on a purchase price adjustment to offset the effect of the increased tax on the sale.[185] A second exception to the anti-churning rules provides that these rules do not apply to property acquired from a decedent if the ba-

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179 *See* Robert Feldgarden & Philip A. McCarty, *Attorneys Identify Glitch in New Intangibles Law*, 93 TAX NOTES TODAY 232-33, Nov. 12, 1993, *available in* LEXIS, Fedtax Library, TNT file.

180 I.R.C. § 197(f)(9)(A)(iii). If an election is made to apply § 197 to assets acquired after July 25, 1991, the date upon which to examine the holding or use of the property is limited to July 25, 1993. *See supra* note 167 and accompanying text.

181 I.R.C. § 197(f)(9)(B).

182 *See supra* note 174 and accompanying text.

183 *Id.* That is, an amount equal to the seller's basis in the property is not subject to § 197.

184 This may or may not be costly for the seller. For example, the seller, in making this election, will lose the potential benefit of the installment sales method and capital gains tax rates. If either of these benefits had application to the seller the election would entail a cost.

185 Of course, any adjustment in price to compensate a seller for the burden of increased federal income taxes is itself taxable. *See* Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

sis of the property is determined under section 1014(a).[186]

C. *Goodwill and Going Concern Value—A Hollow Shell?*

Before turning to the issues incident to a contextual application of section 197, one further, broader issue arises. Just what is left to be categorized as goodwill and going concern value now that section 197 has separately classified and defined various intangibles that previously were considered components of goodwill or going concern value? Additionally, does the answer to the preceding question matter any longer?

Defining goodwill and going concern value has always been somewhat illusive. The struggle to define these assets brings to mind Justice Stewart's famous statement made in attempting to define obscenity: "I shall not attempt to further define the kinds of material I understand to be embraced within that shorthand description . . . . But I know it when I see it . . . ."[187] Oftentimes, courts failed to distinguish at all between goodwill and going concern value.[188] Moreover, the regulations under sections 338 and 1060, classifying goodwill and going concern value as the sole Class IV assets, implicitly failed to even contemplate the fact that these assets may be distinguishable because no mention was made at all of allocating the total Class IV basis between the two.[189]

Goodwill has been variously defined as the "expectancy of continued patronage for whatever reason,"[190] excess earnings capacity,[191] and the benefit derived, beyond the value of capital employed, of "'general public patronage and encouragement which it receives from constant or habitual customers'" for

186 I.R.C. § 197(f)(9)(D) (West 1994). This exception to the anti-churning rules will have a significant impact on partnerships with a § 754 election in effect at the time of the death of a partner. *See infra* notes 297-301 and accompanying text.

187 Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

188 *See, e.g.*, Winn-Dixie Montgomery, Inc. v. United States, 444 F.2d 677 (5th Cir. 1971) (stating that although going concern may be separate from goodwill, using the generic use of the two terms poses no problem); Computing & Software, Inc. v. Commissioner, 64 T.C. 223 (1975) (failing to make a distinction between goodwill and going concern value with respect to the value of existing credit files).

189 The regulations provide a mechanism for allocating basis among the assets of a class for Class II and III assets. Because Class IV is the residual class, this approach offers the practical advantage of avoiding the necessity of obtaining appraisals for these assets.

190 Citizens & Southern Corp. v. Commissioner, 64 T.C. 463, 480 (1988); Conference Rep., *supra* note 47, at 213.

191 Zeropack Co. v. Commissioner, 47 T.C.M. (CCH) 181 (1983); Philadelphia Steel & Iron Corp. v. Commissioner, 23 T.C.M. (CCH) 558 (1964), *aff'd. per curiam*, 344 F.2d 964 (3d Cir. 1965).

whatever reason.[192] As the regulations under sections 338 and 1060 make obvious, goodwill is often defined residually as the amount left over after allocation of amounts to all other assets, which, of course, just begs the question of what exactly is goodwill.

An analysis of section 197 could lead one to believe that goodwill has been absorbed into a combination of several section 197 assets. For example, if goodwill is defined as the expectancy of, or earnings derived by, customer patronage, it is difficult to envision how this asset is to be separated from customer-based intangibles. A customer-based intangible is defined to include market composition, market share, and the value of relationships in generating future sales of goods or services.[193] Perhaps goodwill could include the value expected to be generated from future customers with whom the enterprise has no present relationship, although this would depend on how encompassing the term "relationship" is meant to be. In the event that such an expectancy could be distinguished from a customer-based intangible, it may very well be subsumed into the value of a trademark or trade name, another section 197 asset.[194]

If goodwill is defined as excess earnings capacity, then the reason for such earnings capacity must be determined. Basic economics teaches that excess earnings will not exist for very long in a competitive industry. Therefore, excess earnings will generally exist as a result of a monopolistic market position. If this situation exists other assets are often implicated. For example, monopolistic markets may involve governmental licenses, permits, or significant barriers to entry resulting from patents, processes, know-how, or other such assets. Moreover, establishing excess earnings as a necessary condition for the existence of goodwill will tend to collapse the effect of other factors into goodwill. For example, operating inefficiencies unrelated to reputation or market structure may account for the lack of excess profits.[195]

Perhaps goodwill will be defined residually as the excess of the price paid for all assets over all tangible and intangible assets, including other section 197 assets. This approach, however, would

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192 Metropolitan Bank v. St. Louis Dispatch Co., 149 U.S. 436, 446 (1893) (quoting Story Part. § 99).

193 I.R.C. § 197(d)(2) (West 1994).

194 *See, e.g.*, Fedders Corp. v. Commissioner, 39 T.C.M. (CCH) 1 (1979) (stating that goodwill emanates from and is intertwined with the trade name).

195 *See* Lawrence M. Dubin, *Allocation of Costs to, and Amortization of, Intangibles in Business Acquisitions*, 57 TAXES 930, 933 (1979). It is possible, however, that the persistence of such inefficiencies will eventually erode whatever goodwill is found to exist.

require an independent valuation of the other section 197 assets, relinquishing the obvious administrative relief that section 197 could have otherwise provided. Moreover, if some amount is paid over and above the value of other section 197 assets it must be paid for something, except in cases of appraisal error. As one commentator has asserted, this approach treats goodwill as "nothing more than a meaningless catchword for all the unidentified influences on the earnings capacity of an enterprise."[196]

Going concern value has been defined as an "element of value in an assembled and established plant, doing business and earning money, over one not thus advanced."[197] Factors evidencing going concern value have included a trained workforce, an established product line, and equipment in place.[198] The Tax Court has defined going concern value as the value of not having to rely on internal growth to develop the business to its present stage.[199] Two commentators have explained the nature of going-concern as short run monopoly rents that may be expected to last only until competitors can achieve the efficiencies necessary to eliminate the excess profits.[200]

The distinction between goodwill and going concern value appears to be that goodwill represents the value of prospective advantages, while going concern value takes account of the time frame in which such advantages may be realized. As with goodwill, it is difficult to envision going concern value apart from other defined section 197 assets. Workforce in place, information-based intangibles, supplier-based intangibles, and, conceivably, customer-based in-

196 *Id.*

197 Des Moines Gas Co. v. City of Des Moines, 238 U.S. 153, 165 (1915). The ability to meet operational needs without delay should not be underestimated. Prior to the outbreak of World War I, First Lord of the Admiralty, Winston Churchhill, secured a 51% share of profits of the Anglo-Persian Oil Company and first use of the oil produced by the company's wells for Great Britain. In a speech to the House of Commons describing his acquisition plan he stated that "'[w]hat we want now . . . is a proved proposition, a going concern, an immediate supply, . . . over which we can ourselves preside.'" MARTIN GILBERT, CHURCHILL: A LIFE 261 (1991).

198 *See* Concord Control, Inc. v. Commissioner, 35 T.C.M. (CCH) 1345 (1976).

199 *See* Solitron Devices, Inc. v. Commissioner, 80 T.C. 1, 20 (1983). For a more thorough and thoughtful analysis of the nature of going concern value see Richard L. Doernberg & Thomas D. Hall, *The Tax Treatment of Going-Concern Value*, 52 GEO. WASH. L. REV. 353 (1984).

200 *See* Doernberg & Hall, *supra* note 199, at 372-75. The authors argue, rather persuasively, that asset specific value—assets whose value is greater in the context of a particular production process in comparison to its next best use—will ultimately be included in the fair market value of the asset itself. Likewise, the authors argue that long run monopolistic rents will be reflected in the value of specific assets, such as patents or licenses.

tangibles will capture much of what has been thought of as going concern value.

Does it matter whether we call something goodwill and going concern value? Arguably yes, for several reasons.[201] First, section 1060, at least for the moment, applies in certain cases only when goodwill and going concern value may attach to a group of assets.[202] Presumably, the regulations will be amended to trigger the application of section 1060 where a broader class of intangibles may attach to an acquisition of assets. However, a failure to distinguish at all among section 197 assets would appear illogical.[203] Second, organizational restructuring may result in certain section 197 intangibles being transferred without goodwill or going concern value.[204] Failure to segregate the basis of the latter will distort the tax consequences of the restructuring. Third, it appears that some sort of basis distinction among section 197 will be necessary in any event. For example, covenants not to compete are subject to more stringent loss disallowance rules than other section 197 assets.[205] Moreover, only certain types of assets are governed by section 197 regardless of how acquired—a potentially significant distinction in the event *INDOPCO* is used by the IRS as a bludgeon.[206]

The necessity for a distinction between goodwill and going concern value and other section 197 assets is highlighted by the presence of other rules and requirements, statutory or otherwise, that are based on the presence of goodwill and going concern value. For example, like-kind exchange treatment is categorically denied for goodwill and going concern value.[207] Moreover, state and local income tax laws that do not incorporate the federal tax base, loan covenants, and generally accepted accounting principles, do or may provide for unique treatment of goodwill and going concern value. Assuming that these collateral issues are resolved by an attempt to collapse those section 197 assets that

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201 The distinction among amortizable § 197 assets is important for purposes of determining whether the anti-churning rules apply to a particular asset. *See supra* note 170 and accompanying text. The focus of this section is whether such a distinction matters assuming § 197 applies to all the assets in question.

202 *See supra* note 116 and accompanying text.

203 For example, the application of § 1060 solely because a copyright or patent was acquired would appear overly broad.

204 An acquirer may drop certain assets or operations into a subsidiary, pursuant to § 351. Certain § 197 assets, such as the value of a workforce in place or information-based intangibles, may be transferred without disturbing other § 197 assets.

205 *See supra* note 63 and accompanying text.

206 *See supra* notes 72-103 and accompanying text.

207 *See infra* note 322 and accompanying text.

have been traditionally associated with goodwill and going concern value into the latter two assets, the need for segregating the cost of the various section 197 assets will not be removed. The taxpayer will need a principled foundation on which to support an argument that the assets in question are not goodwill or going concern value in the tough cases—reminiscent of the pre-section 197 quagmire—and to remove those assets that are clearly distinct from goodwill and going concern value.

III. The Application of Section 197 to Retail Rental Real Estate

A. *General Considerations*

The rental real estate industry has not experienced a great deal of difficulty with respect to intangible assets. Traditionally, real estate valuation has ignored the potential existence of these assets and instead has focused on other valuation issues. Intangible assets that received attention tended to be those that—to borrow a phrase from property law—touched and concerned the real property in question, as, for example, easements and leaseholds.[208] The cost allocation issues that taxpayers acquiring rental real estate gave primary emphasis to were the allocation of basis between non-depreciable land and depreciable improvements, and the identification of short-lived tangible assets that could be segregated from the structural components of a building.[209]

The retail real estate industry is comprised of various types of properties. Regional shopping centers, local strip malls, and factory outlet centers, are examples of the types of properties that make up the industry. Moreover, management of the properties

208 Easements, unless granted in perpetuity, are generally amortizable over the term of the easement. *See, e.g.*, Northern National Gas Co. v. O'Malley, 277 F.2d 128 (9th Cir. 1960); Tenneco v. United States, 433 F.2d 1345 (5th Cir. 1970); Rev. Rul. 71-448, 1971-2 C.B. 130. In certain cases, the easement may be amortized over the useful life of property served on the dominant estate. *See* Union Elec. Co. of Missouri v. Commissioner, 10 T.C. 802 (1948), *aff'd*, 177 F.2d 269 (8th Cir. 1949). Leasehold interests that were assigned to the purchaser of real estate were analyzed for purposes of valuing the underlying fee interest to be acquired. It is well settled that separate valuation and amortization of the leases is not permitted. This principal has now been codified in § 167. *See supra* note 155.

209 A related issue, which has importance in certain circumstances, is the allocation of basis among separate parcels of land or segments of a larger parcel. Such an allocation has important consequences in the event less than the entire property will be sold or in cases where an interest in the property is carved out of the larger estate. *See generally*, Fasken v. Commissioner, 71 T.C. 650 (1979); Inaja Land Co., Ltd. v. Commissioner, 9 T.C. 727 (1947).

vary among operators. Some operators prefer to centralize the management functions at one location. Others delegate management responsibilities to local personnel, and some use a combination of these approaches. However, as I will discuss, there is no doctrinal underpinning for the perception that intangible assets play, at most, a tangential role in the success of the enterprises that comprise this industry. No less and no more than other industries the inquiry is a factual one and will vary from property to property depending on the terms of, and circumstances surrounding, the acquisition and operation of the property.

Before analyzing how section 197 could apply to the acquisition of rental real estate, it is helpful to understand why intangible assets tend to be ignored in the valuation of a retail real estate business. Several reasons are plausible.[210] First, traditional real estate appraisal is just that—an appraisal of real estate—and ignores other assets. Three basic methods of valuation are used in appraising real estate. The first method is the cost method. This method values a property at its reproduction cost less an estimated amount of depreciation to reflect the past use of the property.[211] The second method used is the market value method. This method attempts to determine the value of a property by examining recent sales of comparable properties.[212] The third method, the income method, values the subject property by capitalizing earnings at an appropriate capitalization rate or discounting a series of cash flows at an appropriate discount rate.[213] This method is the most com-

210 Neither empirical research nor surveys were undertaken to determine the reasons for the lack of attention to intangible assets. The reasons posited are based on my observations and experience with the industry.

211 Reproduction cost is distinguishable from replacement cost. The latter term represents the cost to rebuild a functionally equivalent structure using existing technology, materials, and design. Reproduction cost is the cost to rebuild an exact replica, at current prices, of the existing structure. The theoretical superiority of using reproduction cost results from the application of depreciation to this figure. The estimated depreciation of a property includes both physical and functional elements. As a result, the existence of new and better technology will negatively affect the value of the property in addition to physical wear and tear. Moreover, this method should distinguish between curable and incurable depreciation. The reduction in value due to curable depreciation is limited to the cost to cure. For obvious reasons this method cannot be used to value land. For a detailed description of this valuation method see ALVIN L. ARNOLD, REAL ESTATE INVESTOR'S DESKBOOK ¶ 1.04[4][a]-[d] (Rev. ed. 1987).

212 This method is most supportable in cases where the property in question is not income producing or is of a type that is actively sold within a given market area. It is also used to value the land component for properties that are valued by the reproduction cost method. *See id.* at ¶ 1.04[3].

213 The selection of a capitalization rate, arguably the most critical variable in determining value, is beyond the scope of this work. Many factors will enter into the selection process, such as the perceived risk of inaccuracy in estimating cash flow, rates

monly used for valuing income producing real estate and is, arguably, the most theoretically sound method for valuing such properties.[214]

The income method requires that the appraiser determine periodic net operating income and a terminal value for the property. Net operating income may be estimated for one year or for a fixed period of years. The net operating income is generally stabilized before a capitalization rate is applied. The stabilization of income takes account of unusual or nonrecurring transactions but will not, typically, distinguish among the sources generating the income. Consequently, the entire stream of income is attributed to the real property.[215] A second explanation for the inattention to intangible assets may be that there was very little incentive for a potential acquirer or seller to seek out intangible assets that may have existed in the package of assets sold. Prior to 1981, a potential buyer could place her emphasis into identifying and segregating the components of the building improvements, many of which could be depreciated over a relatively short useful life.[216] After 1980, the effective date of the Economic Recovery Tax Act of 1981 amendments,[217] the entire structure became depreciable over generously short recovery periods.[218] The prudent course was to avoid the identification of intangible assets that the IRS could categorize as goodwill. Moreover, the seller would typically be indifferent as to whether real property or intangibles were sold because the gain from either type of asset was taxed at similar rates. The Tax Reform Act of 1986 extended the recovery period of residential and

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available on relatively riskless investments maturing in a comparable time frame, and derivations from comparable sales.

214 This method views a real estate investment as representing a stream of cash flows. Accordingly, it is valued in a manner similar to other income-producing property. *See* ARNOLD, *supra* note 211, at ¶ 1.04[5].

215 *See infra* notes 230-32 and accompanying text.

216 Theoretically, periodic depreciation should be the same whether component depreciation is used or not. If the components of a structure were not segregated then the depreciation of individual components should be reflected in the depreciation rates of the structure. *See* Rev. Proc. 62-21, 1962-1 C.B. 418. *But see* Merchants Nat'l Bank v. Commissioner, 554 F.2d 412 (10th Cir. 1977).

217 Pub. L. No. 97-34, § 201, 95 Stat. 172, 203 (1981).

218 The Act provided for the basis of residential and nonresidential real estate to be recovered over 15 years. The Tax Reform Act of 1984 extended the recovery period to 18 years, effective for assets placed in service after March 15, 1984. *See* Pub. L. No. 98-369, § 111, 98 Stat. 567, 631 (1984). In 1985, Congress extended the recovery period to 19 years for assets placed in service after May 8, 1985. Pub. L. No. 99-121, § 103, 99 Stat. 505, 509 (1985). In addition to extending the recovery period of real estate, the post-1981 legislation also modified the methods and conventions used to calculate the cost recovery allowances.

nonresidential real estate to twenty-seven and one-half and thirty-one and one-half years, respectively.[219] However, the imposition of restrictions on the use of passive losses may have tended to negate much of the impetus that could have resulted for paying closer attention to intangible assets.[220] The Omnibus Budget Reconciliation Act of 1993 should, however, provide the impetus for a fundamental change in the process of identifying and valuing the assets acquired in connection with the purchase of a retail rental real estate business.

One final point should be noted. Even if one assumes that an acquisition may properly be considered as merely the purchase of "bricks and mortar"—as in cases where the buyer brings wholesale changes to the management of the property—section 197 cannot be ignored. Section 197 will have application to any shift in ownership that triggers an upward basis adjustment pursuant to a section 754 election.[221] Typically, a change in ownership that does not terminate the partnership will not result in any operational or contractual changes relating to the management of the property. Therefore, it is inconceivable that the possible application of section 197 can be casually dismissed with respect to such basis adjustments.

There are several provisions in the Omnibus Budget Reconciliation Act of 1993 that should prompt potential acquirers to carefully analyze and identify intangible assets during the process of acquiring an existing retail rental property. First, section 197 has eliminated the uncertainty associated with the prospect of an IRS challenge to the amortizability of particular intangible assets. Moreover, the statutory identification and definition of various types of intangibles may serve as an educational tool for the industry. Although real estate has increasingly become the subject of institutional investing, this point may strike those subscribing to the notion that particular industries have peculiar cultures as singularly valid.

The recovery period for nonresidential real estate has been extended to thirty-nine years from thirty-one and one-half years.[222]

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219 Tax Reform Act of 1986, Pub. L. No. 99-514, § 201, 100 Stat. 2085, 2121 (1986).

220 *See infra* notes 276-80 and accompanying text.

221 This assumes, of course, that the property is owned in partnership solution—a relatively safe assumption. *See infra* note 286 and accompanying text.

222 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,151(a), 107 Stat. 312, 448 (1993) (amending I.R.C. § 168(c)(1)). The amendment is effective for property placed in service by the taxpayer on or after May 13, 1993. *Id.* Several exceptions are provided, however. *See id.* § 13,151(b)(2) (exceptions for property

Therefore, the disparity between section 197 amortization, determined by using a fifteen-year recovery period, and depreciation is quite significant. In present value terms, assuming an eight percent discount rate, one dollar of basis subject to amortization under section 197 is worth approximately 187% of the value of one dollar of basis subject to depreciation under section 168.[223] Moreover, relaxation of the passive loss rules with respect to real estate has increased the likelihood that these benefits will be currently realizable.[224]

The application of section 197, however, will not always yield favorable results. The treatment of certain intangible assets under section 197 is less favorable than under the law as it existed prior to the effective date of section 197.[225] Moreover, under certain circumstances, the application of section 197 in general will be detrimental. However, the negative implications of section 197 will be exceptional, and rigorous attention to section 197 will generally prove beneficial to most acquirers.

B. *Specific Applications*

1. In General

The discussion that follows will examine the application of section 197 to the acquisition of a regional shopping center—the prototypical mall. Regional shopping centers tend to be the largest and most complex of the properties comprising the industry. The points discussed below will be equally applicable to other types of properties in the appropriate circumstances. Although the discussion is framed in terms of the acquisition of an entire operation, the points made herein will apply with equal or greater force to transactions generating section 754 basis adjustments.[226]

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placed in service prior to 1994 subject to a binding contract to acquire or construct, or was in the process of construction, before May 13, 1993).

223 This figure was calculated assuming a constant marginal tax rate for 39 years and no restrictions on the ability to use deductions currently. The actual tax rate used has no effect on the present value relationship so long as it is kept constant for the full 39 year recovery period. If the marginal rate is assumed to increase or decrease in later years the present value of the accelerated deductions would be reduced or increased, respectively. The interest rate assumption is an important variable in determining the benefits. A higher assumed interest rate increases the benefit of the accelerated § 197 deductions. The benefit of increased amortization deductions will be reduced, or eliminated, by restrictions on the deductibility of such items. The effect such restrictions will have depends primarily on how long they remain in effect.

224 *See infra* notes 280-85 and accompanying text.

225 *See supra* note 121 and accompanying text.

226 *See supra* note 221 and accompanying text.

Assume a prospective acquirer is seeking to purchase an enclosed regional shopping mall located in a suburb of a major city. The mall has three "anchor" tenants[227]—major department stores—and numerous smaller retail tenants. In addition, the mall may have a small number of tenants leasing office space, a food court,[228] and temporary tenants.[229] The point of departure in the application of section 197 is to identify the existence of intangible assets that fall within the definition of amortizable section 197 intangible assets. Before doing so, however, it is important to overcome a conceptual problem peculiar to the valuation of income-producing real estate.

As previously discussed, the generally accepted method of valuing income-producing real estate is the capitalization of earnings method.[230] This method results in a relatively unrefined process of asset identification.[231] The residual method of allocation requires that goodwill and going-concern value be allocated the excess of the purchase price over the value of identified tangible and intangible assets.[232] Assuming that section 197 assets will be substituted as the recipient of the final residual allocation under section 1060, the methodology used in the valuation of real estate virtually guarantees that there will be little or no allocation to section 197 assets. This result becomes apparent after examining how a residual amount remaining to be allocated arises.

Doernberg and Hall have posited several reasons for the existence of a premium in the value of an enterprise relative to the sum of the values of its constituent assets. One explanation may simply be due to error. Such error could occur as a result of overly optimistic revenue and expenses projections, use of an unrealistically

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227 The use of the term "tenant" in describing the anchor stores may not be accurate in some cases. Often these stores own a fee interest and are not tenants at all. *See infra* note 257 and accompanying text.

228 A food court is a discrete area of the mall with a concentration of food store tenants that typically includes a seating area. Maintenance costs related to the food court area are generally borne by the tenants operating in the food court pursuant to specific lease terms.

229 Temporary tenants are those operating booth-like facilities called kiosks. Although some of these tenants lease space throughout the year most operate on a seasonal basis.

230 *See supra* note 214 and accompanying text.

231 In many cases attention to tangible personal property is given ex-post and intangible assets are ignored, except for rather obvious intangible assets such as covenants not to compete and easements. A possible reason that covenants received attention was that they were purposely bargained for in order to obtain a relatively short recovery period for a portion of the purchase price paid for the assets.

232 *See supra* notes 36-42 and accompanying text.

low discount rate, or a combination of these factors.[233] Another potential source of error lies in the appraisal process. This type of error could result from the failure to identify all assets, thereby creating the appearance of a premium purchase price.[234]

In the event that error does not provide an explanation, a premium could result for three reasons. First, the premium may represent the value to a purchaser of avoiding start-up costs.[235] The investment in start-up costs by the seller is a necessary but not a sufficient condition for the existence of premium. The authors note that current market conditions may erode or eliminate the value of a start-up investment.[236] Moreover, in certain cases a potential buyer may not place any value on such investment by the seller because the buyer may redeploy, at very little cost, resources from similar businesses that the buyer presently operates.

A second explanation for the existence of a premium, absent valuation error, is the existence of assets that have unique value as part of the seller's enterprise in excess of their next best use.[237] In the event the seller's industry is characterized by the existence of many firms, the ability of other firms to use these assets in a similar fashion will, eventually, cause the market price of the asset to rise and eliminate the premium.[238] Accordingly, the existence of this type of asset is exceptional.

A third rationale for the existence of a premium is the ability of an enterprise to earn excess profits that competition cannot eliminate in the short-run.[239] In the event long-term excess profits may be generated, then this fact often points to the existence of other assets, such as patents, trademarks, or government licenses.[240] Alternatively, continuing cost advantages point to other assets such as management skill, a unique production process, and like assets which should be separately valued and amortized.[241]

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233 *See* Doernberg & Hall, *supra* note 199, at 367.

234 The authors attribute the failure of generally accepted accounting principles to reflect self-created intangibles on the balance sheet as one possible factor leading to this result. Moreover, the appraiser's natural inclination to achieve tax results desirable to her client may provide a further explanation. *Id.* at 367-69.

235 *Id.* at 369-70.

236 *Id.* at 369.

237 *Id.* at 372.

238 *Id.*

239 For a brief discussion of why short-run excess profits exist in a market with little or no barriers to entry see RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 9.5 (3d ed. 1986).

240 Doernberg & Hall, *supra* note 199, at 373.

241 *Id.*

Any explanation put forth for the existence of such a premium presupposes a discrete and calculable market value for identifiable assets. If, however, the valuation of the tangible asset or assets in question depends upon the income projected from the entire business, the possible existence of a premium allocable to intangible assets is foreclosed. The existence of circumstances such as those described by Doernberg and Hall are collapsed into the value of the property being valued. Yet that is how real estate is typically valued. It is not difficult to explain why this has occurred. Each parcel of real estate is unique. Although reference may be made to the value of comparable properties, differences will exist among properties. Consequently, it is difficult to isolate a value for the tangible assets, a necessary step in the determination of whether a residual value exists. Moreover, even if comparable properties were used as a baseline, if they were valued under existing methodologies, their valuations will reflect the same problem that should be avoided.

Moreover, unlike other businesses that may contain thousands of assets, each of which may be relatively useless to the business in question without the others, the success of the real estate enterprise is easy to identify with the property under valuation and that property alone. However, the conceptual framework established by Doernberg and Hall may be applied to the retail real estate industry. An analysis of the various intangible assets that may be acquired by a prospective purchaser of a retail property will show that these assets lend themselves to classification based on the three explanations discussed above. Those assets that result in the buyer foregoing start-up expenditures should be separated from the valuation of the "bricks and mortar." Those assets that create short-run excess profits should likewise be separately valued. All other intangible assets should continue to be treated in the manner in which they have been traditionally handled—as part of the cost of the acquired property or, in rare cases, as a separate asset.

2. Potential Section 197 Intangibles

The analysis that follows is organized by the type of section 197 intangible identified in the statute.

a. *Workforce in Place*

Section 197(d)(1) provides that a workforce in place, including its compositional elements and terms and conditions of its employment, is a section 197 intangible. Moreover, the value arising from the terms and conditions of employment need not be contractually based.[242]

The relative importance and, in some cases, the existence of, an intangible asset consisting of the value of an existing workforce will depend on several factors. Probably the most important variable is whether the property has been wholly or partially managed by an independent agent or by the seller directly. In the former instance, the business may have little or no workforce and much of the value associated with this asset may be shifted to supplier-based intangibles if the seller's management agent is retained by the acquirer.[243]

In the event the seller's employees performed operational functions and will be retained by the buyer, a key variable in determining the value of this asset is whether the functions to be performed by these employees for the buyer are centralized or decentralized. Centralization may occur if the acquirer is already in the business and manages several other properties. If the functions that are to be performed by these employees are centralized, it is arguable that the value of particular employees will be less than they would have been otherwise because, presumably, centralization is usually undertaken to standardize processes and procedures. This fact should call into question the extent of any value actually generated by the employees themselves.

The analysis should begin with the acquisition agreement and the proposed plan for management of the property. The assumption of specific contracts, such as union agreements and individual employment contracts, should be noted. Moreover, because the existence of a contractual relationship is not a prerequisite to application of section 197, the acquirer's plans for retention or replacement of employees in general should be understood.

Analyzing the business along functional lines is a useful exercise in identifying potential value with respect to an existing workforce. Leasing department employees, the primary revenue generators, could be a potential source of significant value. The extent of the value attaching to these employees will depend on several factors such as the level of their experience, the nature and extent of their relationships with the property's target tenants, and present salary and commission levels. Employees performing general management functions could also be an important source of value. For example, tenants may value continuity in dealing with

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242 I.R.C. § 197(d)(1)(C)(i) (West 1994). *See also supra* notes 76-81.

243 *See infra* note 265 and accompanying text.

the landlord's representatives. Moreover, managers that have had a long history with the property may provide valuable insights into solving or preventing a variety of problems that inevitably arise.

The threshold inquiry in valuing this asset should focus on the savings to the buyer of not having to hire and train a workforce.[244] Included in the savings should be the opportunity cost inherent in establishing a new workforce. For example, if existing leasing department personnel could acquire leases immediately on terms that may take a start-up department several years to achieve, then the value attributable to this temporary difference in income should be assigned to this asset. It should be obvious that facts and circumstances will play the dominant role in making these determinations. For example, if the mall at issue has had no vacancies in years and has a long tenant waiting list, the value attributable to existing leasing personnel may be minimal.[245]

b. *Information-based Intangibles*

Several items of value could exist within this category. Often overlooked is the value of acquiring the books of the seller as they relate to the property in question. Typically, the acquisition of a property will be carried out by a separate entity, thereby diminishing the potential for significant value to attach to historical income tax and financial reporting records.[246] However, books of original entry, such as billing registers, cash receipts journals, as well as analytical papers and tenant data files, could have continuing utility to an acquirer.[247] Moreover, this type of intangible asset will also encompass information relating to the leasing function. For example, lists of potential tenants, and background and credit

244 In some cases compositional factors alone may have value. *See supra* notes 76-80 and accompanying text.

245 Similar results would arise in the event the buyer could redeploy seasoned personnel from other properties at minimal cost in the short run.

246 In the case § 197 is operative due to § 754 adjustment, historical tax and accounting records would have continuing utility and, consequently, may contain a significant amount of value. This assumes, of course, that the § 754 adjustment was not made as a result of a transaction that terminated the partnership under § 708. *See infra* note 293 and accompanying text.

247 These records may prove extremely useful, for example, in resolving disputes with tenants over prior billings and in providing information to tenants relating to the calculation of particular lease charges, especially those charges subject to formula calculations. Although requests for tenant estoppel letters are a standard due diligence procedure performed in the acquisition process, in many cases these disputes arise post-acquisition and are not subject to the estoppel letter. Moreover, diligence in handling tenant inquiries is often the least costly method of resolving potential disputes.

information with respect to potential tenants will be included in this category.

It should be evident at this point that there may exist an inverse relationship between the value of this asset and the value of a workforce in place. In essence, much of the value of this information may be subsumed into the value of the workforce in place if much of this information is not readily available except through the experience of particular personnel.[248]

The items discussed above fit nicely into the Doernberg and Hall framework. To the extent these items have utility to a buyer they allow the buyer to avoid the start-up costs necessary to create them. It is also plausible to categorize these assets—using Doernberg and Hall's terminology—as "specific assets." That is, they have value only as they relate to the business operated by the seller.[249]

c. *Processes, Designs, Know-how, or Similar Items*

Included in this category of section 197 intangibles are formulas, processes, designs, patterns, know-how, format, and the like. The nature and extent of the assets that comprise this category will depend on all the facts and circumstances surrounding the operation of the property and its acquisition. Among the assets that may be acquired are promotional designs and logos for the mall. The increasing sophistication of data base systems and computer networks may result in the acquisition of custom network software or data base programs.[250]

An interesting possibility is the assignment of value to an established "tenant mix." This term refers to the type and arrangement of tenants within a mall to maximize customer traffic and

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[248] One would expect to find a negative correlation between the value of records in a form readily useable by an outsider and the value of a workforce in place. The lack of access to critical information via written or electronic medium should tend to increase the value of personnel that have the desired information "in their head."

[249] Unlike the authors' view of the prototypical "specific asset," it is difficult to conceive of a situation where a competitive market will eliminate the unique value of these assets. *See supra* note 238 and accompanying text.

[250] Many of these systems may be purchased as a standard package—that is, "off the shelf,"—in which case they will be excluded from § 197. *See supra* note 150 and accompanying text. However, many systems are quite sophisticated and are integrated into a network application allowing access of tenant information by several departments or functions and integrate the accounting, budgeting, leasing, and management functions. An obvious use of networks would be to link tenants with the landlord. For example, sales data for determining percentage rentals and generating sales data by industry could be provided by electronic means in real time, or in any event, in a more timely fashion than is possible by paper report.

rents. Whether section 197 will apply to this asset depends on how the term is defined. The value of existing leases are excluded from the application of section 197.[251] If a "tenant mix" is considered as merely the conglomeration of all existing leases then it may fall outside section 197. However, a "tenant mix" may also refer to a pre-conceived plan that establishes a target for prospective leasing efforts resulting from considerable expenditures of time and money by the seller.

d. *Customer-based Intangibles*

A customer-based intangible is defined to include the make-up of the market, share of the market, and "any other value resulting from the future provision of goods and services pursuant to relationships . . . in the ordinary course of business with customers."[252] This rather expansive definition raises a significant issue in the context of retail real estate. Given that only the value of existing leases is expressly excluded from section 197, may a purchaser attribute the value of future leases to customer-based intangibles? The answer appears to be a qualified no. Several reasons appear to prevent such a result.

First, the definition of customer-based intangibles refers only to the provision of goods and services, neither of which is the subject matter of a standard lease.[253] Second, a useful analogy is provided by the case law that exists with respect to the issue of whether the value of leases could be separately amortized apart from the fee interest. Although these cases dealt with existing leases, they are instructive in highlighting the courts' view of the value generated by the ability to lease a property. The courts have found that the value inherent in the leases is indistinguishable from, or merges with, the fee and, moreover, have failed to see any distinction between premium leases and market rate leases in reaching their con-

251 *See supra* note 152 and accompanying text.

252 *See* I.R.C. § 197(d)(2)(A) (West 1994); *supra* notes 89-91 and accompanying text.

253 A lease provides a tenant with a possessory interest in the property—that is, the use of a space. Services such as trash removal and maintenance, if provided, are incidental. The Internal Revenue Code does, in certain cases, make the distinction between goods, services, and leases. Section 461(h)(2), for example, distinguishes between the provision and receipt of goods and services and expenditures relating to the use of property in defining the type of expenses subject to the economic performance rules. I.R.C. § 461(h)(2) (1988). It may be argued, however, that the value associated with providing customers with the use of property may fall under § 197(d)(1)(C)(vi) (defining § 197 intangibles to include "any similar item" to those items enumerated).

clusions.[254] The framework provided by Doernberg and Hall supports this conclusion. The ability to generate future lease rentals, whether premium or market based, will generally result from attributes that establish a long-term competitive advantage and, accordingly, should be incorporated into the value of the underlying property. Favorable location, monopolistic market position due to restrictive zoning laws, neighborhood affluence, and access to major arteries, the principal factors that generate the potential for future income, are permanent in nature.

Moreover, in the event that any value may be assigned to future lease income as a result of short-term competitive advantages, the nature of the industry virtually assures that any such value will be minimal. For example, assume that a shopping center could charge premium rents because its management is particularly good at keeping expenses low, marketing the center, and properly mixing the tenants. Because existing leases are expressly excluded from the definition of section 197 intangibles, the value of these skills must be projected out to prospective leases. The acquisition of these leases will necessarily have to await the termination of the existing leases. As a result, the value inherent in having a workforce in place, as it relates to the ability to generate lease income, will eventually disappear.[255]

There are circumstances, however, that may support the existence of a customer-based intangible resulting from future lease income. The threshold issue is whether such income can be identified as originating from a source or advantage that is distinct from the property itself. For example, if management or marketing skills can be shown to be difficult to duplicate in a long-term time frame then attributing this value to the workforce in place may be supportable.[256]

Another possibility for identifying a customer-based intangible

254 *See, e.g.*, Schubert v. Commissioner, 33 T.C. 1048 (1960); Peters v. Commissioner, 4 T.C. 1236 (1945); Friend v. Commissioner, 40 B.T.A. 768 (1939). *But see* Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), *rev'g*, 15 T.C. 906 (1950) (holding that a premium paid for a favorable lease was amortizable and upholding separate amortization for the leasehold value). For an excellent analysis of these cases see Morris & Glicklich, *supra* note 155, at 94-106.

255 The validity of this assertion is based on the premise that the expertise generating this additional value may be duplicated by other participants in the market. If this premise is valid then the longer the life remaining on existing leases, the more likely that this advantage has little or no value because it could have been readily acquired by the time the existing leases terminated.

256 An example may be found in temporary tenant programs or special events programs. In many cases these programs have a unique theme whose success may be attributable to long-term relationships with management personnel. However, it may

may exist with respect to operating agreements with anchor stores. These agreements may possess value because of discrete favorable terms within the agreements or simply as a result of the identity of the anchor store. Two broad questions are presented by these agreements. First, are they excluded from section 197 by one of the statutory exceptions? Second, assuming they are not excluded, do they fall within any of the definitions of section 197 assets?

Many anchor tenants own the fee interest in their sites and are not privy to a lease agreement at all. Their rights and duties with respect to the fee owner of the mall proper is embodied in an operating agreement. These agreements deal with issues such as common area charges, parking, trash removal, utilities, store hours, security, and the like. Moreover, these agreements provide for cross-easements and use restrictions. On a technical basis, these agreements may be distinguished from a lease of the subject premises.[257] Doctrinally, however, making this distinction is difficult and it is not clear whether the IRS or a court would accept the distinction.[258] Moreover, these agreements as a whole—not merely the value of the cross-easements—may be considered an interest in land, and thereby categorically denied section 197 treatment.[259]

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be difficult to show that the value generated from these programs is not a result of the desirability of the property itself.

257 Section 167(c)(2)(A) precludes the allocation of basis to the value of a leasehold interest. I.R.C. § 167(c)2(A) (West 1994). Therefore, the fact that a tenant may have a positive effect on the lease terms a landlord could obtain from other tenants will have no effect on the ability to segregate this value from the fee interest. However, the statute's application is limited to leasehold interests and, technically, would not govern non-lease contractual rights. Similarly, § 197(e)(5) excludes existing leases from § 197 and makes no reference to other contractual arrangements. *Id.* § 197(e)(5). However, if an operating agreement grants the shopping center owner the right to purchase the property either after the expiration of a fixed period of time or in the form of a right of first refusal, it is possible that such right may cause the agreement to fall under the § 197(e)(2) exclusion for "any interest in land." *Id.* § 197 (e)(2). Moreover, if the anchor tenant is operating under a ground lease the operating agreement may, arguably, be collapsed into the ground lease thereby excluding the operating agreement from § 197.

258 It is difficult to articulate a distinction between the value of having a particular operation attached to the property and the value of having an operation located in the vicinity of the property. For example, the value of having a property located near a major employer may create additional value but that value is indistinguishable from the property itself. The fact that the operation is subject to an operating agreement may provide a less ambiguous ground for establishing a value but it does not support, per se, the separation of that value from the fee interest.

259 Similar issues have arisen in bankruptcy under 11 U.S.C. § 365 (1988). This provision provides a debtor in possession with the option to reject executory contracts. The courts have had to resolve the question of whether certain types of covenants are executory contracts, subject to rejection, or are real property interests that may not be rejected. Some courts appear to focus on whether the covenants "run

Assuming that operating agreements are not expressly excluded from section 197, it is not clear whether they fall within any category of section 197 assets. It is conceivable that the value of these agreements, or a portion thereof, are customer-based intangibles and, possibly, supplier-based intangibles.[260] It is also arguable that the beneficial effect a particular anchor store may have on attracting tenants may be categorized as part of the value of the market composition—that is, a customer-based intangible.

e. *Supplier-based Intangibles*

Supplier-based intangibles are defined as the "value resulting from the future acquisition of goods and services pursuant to relationships . . . in the ordinary course of business."[261] This category of section 197 intangibles generally presents the fewest identification and valuation problems. Shopping center owners enter into numerous service and supply contracts. Common types of contracts would include maintenance, landscaping, trash and snow removal, security, advertising, public relations, accounting, legal, and leasing contracts. A less obvious relationship[262] that may have

with the land." If they do, these courts have held that they are real property interests not subject to rejection. *See, e.g.*, *In re* Case, 91 Bankr. 102 (Bankr. D. Colo. 1988) (holding that the obligation to contribute to a condominium association was not severable from the real property and, hence, could not be rejected).

Analogy to bankruptcy law, however, may not be entirely satisfactory. First, the courts were faced with the possibility that a debtor could reject her obligations under the covenant while, at the same time, retaining the property to which the covenant related—a seemingly inequitable result. Second, the courts' resort to property right labels were made in an attempt to distinguish these rights from executory contracts under the bankruptcy law. Every contract creates a property right. The issue, for purposes of § 197, is not whether a property right exists but whether an "interest in land" exists. The fact that a covenant "runs with the land" does create such an interest at common law. In fact, the *raison d'etre* of the law of real property covenants is that the law refused to recognize such arrangements in the form of easements—which are an "interest in land." *See supra* note 149. Moreover, taken to its extreme, this reasoning would seemingly apply to many covenants not to compete, causing them to be considered an interest in land, an odd result considering the unambiguous inclusion of covenants not to compete in the definition of § 197 assets. *Infra* note 272 and accompanying text.

260 To the extent the value of the agreement is generated by services to be provided by the owner of the shopping center or the anchor store, the agreement would appear to qualify under I.R.C. § 197(d)(2) or (3) (West 1994).

261 *See* I.R.C. § 197(d)(3); *supra* notes 92-94 and accompanying text.

262 The landlord may be obligated to contribute to the funding of the association. The obligation may arise from a direct contractual relationship with the association or through individual tenant lease provisions. In the latter case, the association would be a third party beneficiary of the lease contract and the relationship may properly be viewed as a contractual one. *See generally* RESTATEMENT (SECOND) OF CONTRACTS §§ 302-15 (1979).

value is the landlord's relationship with the mall merchant association. A merchant association is a separate legal entity, usually a not-for-profit corporation,[263] formed by the tenants of the mall to promote the mall as a whole.[264] Conceptually, the methods used to value this relationship should be similar to those used for determining the value of any marketing or advertising relationship.

Management contracts that are acquired or assumed may be a significant supplier-based intangible. In fact, an inverse relationship should exist between the potential value of this asset and the potential value of a workforce in place. The broader the scope of services performed by an independent management company, the less significant one would expect the services performed by employees to be, and vice-versa. Valuation of these contracts should be performed under the framework used to evaluate workforce in place. The fact that there exists an industry specializing in the management of the property tends to militate against the existence of significant organization cost value.[265] Therefore, much of the value that will be found here should focus on short-term transition cost savings and the existence of favorable pricing in the existing contract, if it is assumed.[266]

f. *Licenses, Permits, and Government-granted Rights*

The existence of governmentally granted privileges will generally be subsumed into the value of the property itself. For example, although the legislative history mentions only zoning variances and building permits, favorable parking lot density rules, set back requirements, the effect of closing laws and the like should be treated analogously.[267] Moreover, these items are properly categorized with the physical asset under the Doernberg and Hall framework. There may be certain items, however, that are separable from the property itself. For example, liquor licenses acquired by

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263 These organizations are not, however, exempt from federal income taxes.

264 The merchant association is funded by dues assessed upon the tenants and, in some cases, by matching contributions from the landlord.

265 However, one should not hastily assume that the existence of such an industry diminishes the potential value of an existing workforce in place. The fact that services are provided by employees despite the existence of such an industry may actually point to the existence of value from the workforce—otherwise an independent agent could have been employed.

266 In many cases, an acquirer will retain the existing management company solely to effectuate an orderly transition to internal management or its own independent management company.

267 *See supra* note 98 and accompanying text. It is also possible that the courts would hold that these assets merge into the property, similar to the merger found to exist with leases. *See supra* note 155 and accompanying text.

the landlord would fall under the definition of a section 197 intangible.

The existence of a temporary real estate tax abatement poses an issue. If the abatement merely creates a temporary advantage then, arguably, it could be separated from the value of the property.[268] However, two arguments may be made that section 197 should not apply to tax abatements. First, most of the real estate taxes assessed to the landlord are billed to tenants pursuant to specific lease provisions. Arguably, therefore, much of the value of the abatement should be allocated to the leases which, of course, takes it out of section 197.[269] Second, it is plausible that a real estate tax abatement is not a "right" granted by a governmental unit for purposes of section 197(d)(1)(D).[270]

g. *Covenants not to Compete*

A covenant not to compete entered into with the seller or employees of the seller poses no special problems for purposes of section 197. As discussed above, section 197 will have a significantly negative impact on the tax consequences of covenants not com-

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268 If the tax abatement is relatively long-lived, a strong argument may be made that the value of this right should be subsumed into the building valuation analogously to a zoning variance.

269 Two theories may be used to explain this result. First, the fact that real estate taxes are passed through to the tenants calls into question whether the right or privilege was granted, in substance, to the tenants. Second, the reduced real estate tax burden may allow the landlord to increase other lease charges, such as minimum rent. There is a danger, however, in this latter theory. Taken to its extreme, it could be used to require any efficiencies on the landlord's part to be allocated to the leases. Perhaps it is easier to justify in this context because it is a readily ascertainable figure of known duration.

270 Based on the various definitions of the term "right," it is difficult to articulate an argument that a tax abatement is not a right. Each of the definitions could support a legally enforceable claim to avoid otherwise applicable duties. *See* BLACK'S LAW DICTIONARY 1189 (5th ed. 1979). Moreover, if an attempt is made to distinguish a "right" from the reduction, or elimination, of a pre-existing obligation, it is difficult to rationalize why many permits would qualify but a tax abatement would not. Perhaps a distinction can be drawn by the fact that permits typically relieve a party from the obligation not to act—a negative duty—while a tax abatement relieves a party of the obligation to act—the positive duty to pay taxes. I am not satisfied with such a distinction.

An attempt may be made to distinguish an abatement from other governmentally granted rights on the grounds that an abatement relates solely to the real property and, therefore, cannot be distinguished from the property. Many permits also relate solely to real property. For example, the ability to discharge a given quantity of air pollutants would relate solely to the factory or plant for which the permit was granted. Moreover, this comparison carries greater force if the abatement is conditioned on a specific use of the property.

pete in relation to prior law.[271] It should be noted, however, that the buyer of real estate may also be, in effect, purchasing any covenants not to compete that the seller had previously entered into. This is because state law may allow these covenants to "run with the land."[272] However, the value of these acquired covenants would not be subject to section 197 because they would not have been "entered into" or "created" in connection with the acquisition.[273]

Existing leases may contain provisions that prohibit the tenant from conducting business within a proximate geographic area during the term of the lease. It appears that section 197(e)(5)(A) will preclude a separate valuation of these provisions. Moreover, well established judicial doctrines will prevent achieving this result through the use of separate agreements.[274]

h. *Trade Name*

In the event the purchased shopping center has a distinctive name or trademark that is also acquired, the value of this name or mark should qualify as a section 197 asset. To the extent that shopping center operators are marketing the mall itself more aggressively, it is arguable that the name or mark has a marketing value that is distinguishable from the property itself.[275]

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[271] *See supra* note 121 and accompanying text.

[272] In order for a covenant to "run with the land," courts have imposed a requirement that the covenant touch and concern the land. The critical issue, from the buyer's perspective, is whether the benefit of the covenant will run. Courts vary over whether both the benefit and burden of the covenant must touch and concern the land in order for the benefit to run with the land. Generally, this test required that the burden of the covenant affect the physical use of the land itself, a condition that often proves difficult to satisfy.

A modern trend is developing, however, that applies a reasonableness standard to determine whether the burden of a covenant will run. *See* Davidson Bros., Inc. v. D. Katz & Sons, Inc., 121 N.J. 196 (1990) (holding that the touch and concern requirement is but one of the factors to be considered in determining reasonableness). Note that in certain circumstances a buyer may be directly concerned about the running of the burden. This situation could arise where a neighboring parcel of land contains a covenant restricting the use of the property to the favor of the buyer and the owner of that parcel sells it to a third party.

[273] *See supra* note 69 and accompanying text. Provided these covenants are not deemed to be an interest in land, they should be amortizable over the remaining term of the covenant under the law prior to § 197. The IRS may assert, however, that any covenant that "runs with the land" is an interest in land. *See supra* note 259 and accompanying text.

[274] *See, e.g.*, McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982) (providing an excellent discussion of the various formulations that exist in the application of the step transaction doctrine).

[275] For example, malls, either directly or through the merchant association, are increasingly selling gift certificates that are useable in any store in the mall. Moreover, there is apparently no reason why the nature of the impact of a mall name or

After the identification and valuation process is complete, an analysis of the potential impact of section 197 on the retail real estate industry must consider the impact of the passive loss rules. A detailed discussion of these rules is beyond the scope of this work.[276] However, it is important to recognize the relationship of these rules to the benefits achievable through aggressive application of section 197. The benefits of the relatively rapid cost recovery provided by section 197 will be diminished or eliminated if those deductions are not currently available to offset other income.[277] In some cases, the increased deductions resulting from the application of section 197 may actually be detrimental due to certain peculiarities in the application of the passive loss rules.[278]

Losses arising from a passive activity may be deducted to the extent of income generated from passive activities. Rental activities are presumptively passive.[279] However, section 13143(a) of the Omnibus Budget Reconciliation Act of 1993 amended section 469 by adding a relief provision for certain rental real estate activities. In general, the rental real estate activities that qualify under the new rules will not be considered a passive activity.[280]

In order for a taxpayer to avail herself of this rule, more than one-half of the personal services performed in trades or businesses by the taxpayer must be performed in real property trades or businesses in which the taxpayer materially participates.[281] Moreover, more than 750 hours of services must be performed in those real property trades or businesses.[282] The statute provides an elective provision whereby all interests in rental real estate will be treated as

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logo on the success of a real estate business should be any less than the impact of a trade name or trademark on the success of other businesses. Any difference would be one of degree.

276 For a comprehensive analysis of these rules see *Passive Loss Rules*, 454-2nd, Tax Mgmt. (BNA); *see also* Thomas J. Gallagher, Financing Real Estate Projects ¶¶ 1105-1120 (CCH Tax Trans. Lib. 1990) (providing an analysis of the passive loss rules as they affect the financing of real estate ventures).

277 The application of the at-risk rules will have similar effects. *See generally* I.R.C. § 465 (1988 & Supp. IV 1992). These rules do not, however, apply to rental real estate with the same regularity as found with the passive loss rules.

278 For example, if a taxpayer gifts an interest in a partnership, any suspended passive losses with respect to that interest is added to the donee's basis in the partnership interest. *See id.* § 469(j)(6) (1988). Consequently, the passive losses added to the basis may be trapped within the basis of the partnership interest until the donee subsequently disposes of the interest. Section 197 could have the effect of increasing the amount of this suspended loss.

279 *Id.* § 469(c)(2).

280 *Id.* § 469(c)(7)(A)(i) (West 1994).

281 *Id.* § 469(c)(7)(B)(i).

282 *Id.* § 469(c)(7)(B)(ii).

one activity.[283] Generally, because most owners of rental real estate will not be deemed to materially participate in any single rental real estate business, the ability to aggregate all activities is critical to qualifying for this relief provision.[284] Unfortunately, the statute appears to prevent limited partners from aggregating properties.[285] Therefore, in most cases, a limited partner will be subject to the passive loss rules.

IV. Collateral Issues

The impact of section 197 on the retail real estate industry cannot be fully measured without surveying several collateral issues. These issues may be organized into three broad areas. First, the effect of using the partnership form of business on the application of section 197 will be considered because it is the predominant form of business for holding rental real estate. Second, section 197 may have effects on existing and future agreements that should be identified and understood. Third, the existence of section 197 assets will have an impact on the tax consequences of disposing of the acquired property.

A. *Application of Section 197 in the Partnership Context*

The partnership form is the favored form of organization for holding and operating real estate investments.[286] In the context of

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283 *Id.* § 469(c)(7)(A).

284 Material participation is defined as the involvement in the operations of an activity on a regular, continuous, and substantial basis. *Id.* § 469(h)(1) (1988). The regulations provide several objective tests for meeting this standard, none of which is likely to be met by an owner of multiple activities. *See generally* Temp. Treas. Reg. § 1.469-5T(a) (1992). Limited partners are not treated as material participants except in certain circumstances and, accordingly, are less likely to meet this test for an individual activity. *See* Temp. Treas. Reg. § 1.469-5T(e) (1992).

285 I.R.C. § 469(c)(7)(A) (West 1994) states that "[n]othing in the preceding provisions . . . shall be construed as affecting the determination of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner." This language appears to preclude a limited partner from electing to treat all interests in rental real estate as one activity. However, if a limited partner also owns a general partnership interest at all times during the partnership's taxable year then, for purposes of the passive loss rules, the partnership interest in question will not be treated as a limited interest. Temp. Treas. Reg. § 1.469-5T(e)(3)(ii) (1992).

286 A detailed analysis of the reasons that the partnership form is preferred is beyond the scope of this work. In general, the partnership form offers several advantages over the C corporate form of doing business, principally the avoidance of a tax at the entity level. *See* I.R.C. § 701. A S corporation offers a similar advantage, but in certain cases may be subject to a corporate level tax. *See id.* § 1374. A partnership also offers several advantages over S corporations. Among these advantages are the ability of a partner to include her share of partnership debt in basis; flexibility in allocating income and loss; elective basis adjustments upon the entry of new partners or liquida-

the acquisition of retail rental real estate, the use of the partnership form presents several issues. The acquisition may take one of several forms. First, the partners may acquire real estate directly and contribute the assets to a partnership. Second, a partnership may be used to acquire the assets directly. Third, the acquirers may purchase the partnership interests of the sellers, assuming the sellers operated the business through a partnership.

The first alternative generally poses no particularly difficult issues. The acquisition of the assets by the individual partners will be governed by section 1060 and, as a result, the section 197 assets will obtain a cost basis determined after the application of the residual allocation method. The contribution of the assets to the partnership will result in the partnership obtaining a carryover basis in the section 197 assets.[287]

However, complications arise in the event section 197 assets whose basis does not reflect their value are contributed by one or more of the partners. This situation could arise where one or more partners acquire, or have previously acquired, the real estate business and another partner contributes cash or other property. Section 197(f)(2)(A) provides that the transferee partnership shall be treated as the transferor for purposes of applying section 197. Under general partnership basis rules, the partnership's basis in the section 197 assets will equal the transferor's basis in those assets. The non-contributing partners may, pursuant to section 704(c), receive allocations of amortization that reflect the fair market value of the assets. Recently issued regulations provide three alternatives for allocating deductions attributable to appreciated property.

The first alternative is the traditional method of allocating such deductions. The noncontributing partner is allocated deductions reflecting the fair market value of the property but limited, by

tion of existing partners; and no restrictions on the type or number of persons that may be a partner. For a succinct overview of the federal income tax differences between the partnership and S corporation forms of business see PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION OF PARTNERSHIPS AND S CORPORATIONS 319-22 (1991).

The potential disadvantage of unlimited liability may be controlled through use of a limited partnership. Moreover, many states are allowing limited liability companies as an alternative form of doing business. These entities will be taxed as either corporations or partnerships, depending upon the terms of the applicable governing statute and the internal management structure of the entity. For an extremely thorough analysis of the legal and tax aspects relating to these entities see Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992).

287 *See* I.R.C. §§ 723 (1988); 197(f)(2) (West 1994).

the so-called ceiling rule, to the partnership's total tax deduction.[288] A second method provides for similar results but allows for a curative allocation of similar type deductions to eliminate any reduction in the original allocation as a result of the ceiling rule.[289] The third alternative, the remedial method, allows an allocation of deductions to alleviate the effect of the ceiling rule, but, unlike the second alternative, is not limited to allocations of similar type deductions.[290] The remedial method replaced the deferred sale method that was included in proposed regulation section 1.704-3(d) issued in December 1992. However, it is not clear whether the general anti-churning rules will apply to remedial allocations while it is fairly safe to assume these rules would have applied under the deferred sale method.[291]

If the transaction is structured as a direct acquisition of assets by the partnership, then section 1060 will apply, at the partnership level, and the allocation of basis to section 197 assets is relatively straightforward. The general anti-churning rules will need to be examined but, typically, they will not apply if the parties to the transaction are not related persons as defined by section 197(f)(9)(C).[292]

The acquisition may also take the form of the purchase of partnership interests. The partnership will terminate, for federal income tax purposes, upon the sale or exchange of fifty percent or more of the total interests in partnership capital or profits.[293] Consequently, the partnership is considered to have distributed its assets to the partners in complete liquidation of the partnership. The partners, in turn, are deemed to have contributed those assets to a new partnership.[294] The partners' basis in the assets that they are deemed to have received in the constructive liquidation of the partnership will be equal to the basis of their partnership interests

288 *See* Treas. Reg. § 1.704-3(b)(1) (1993).

289 *See id.* § 1.704-3(c).

290 *See id.* § 1.704-3T(d).

291 The deferred sale method treated the contribution of property as a sale. The remedial method does not resort to creating a fictional sale but merely shifts deductions among the contributing and noncontributing partners. Therefore, it is arguable that there has been no transaction causing the anti-churning rules to apply.

292 The anti-churning rules could apply in certain instances, however. For example, if employees held more than a 20% interest in the selling partnership and, pursuant to the agreement, retain their interests through the buying partnership, the anti-churning rules would apply. Moreover, the anti-churning rules will apply in the event the transaction is a sale-leaseback, although such transactions are not very common in the context of a shopping center acquisition.

293 I.R.C. § 708(b)(1)(B) (1988).

294 Treas. Reg. § 1.708-1(b)(1)(iv) (1983).

and is allocated among the individual assets, with certain exceptions for unrealized receivables and inventory, in proportion to the adjusted basis those assets had within the partnership.[295] The basis of the individual assets thus determined become the basis of the assets to the new partnership that is constructively formed.[296]

The application of these rules, at first blush, would appear to preclude the allocation of basis to most section 197 assets because the inside basis of these assets in the hands of the selling partnership will generally be zero. Two possibilities exist for the acquiring partners to avoid this result. First, if the partnership has a section 754 election in effect, the partnership will adjust the inside basis of its assets, for the benefit of the purchasing partners, to reflect the price paid for the assets.[297] Section 197(f)(9)(E) expressly provides for such adjustments without automatically triggering the anti-churning rules.[298] Moreover, in the event a section 754 election is not in effect, the purchasing partners may elect to achieve the same result through a section 732(d) election.[299] As in the case of the basis adjustments pursuant to section 754, elective basis adjustments pursuant to section 732(d) will not automatically trigger the anti-churning rules.[300]

The ability to adjust the inside basis of partnership assets to reflect the purchase price of those assets will not, however, guarantee that the basis of those assets will be equivalent to the basis that would have been obtained under an allocation pursuant to section 1060. The adjustments to basis arising from section 754 elections must be allocated pursuant to the regulations under section 755. These regulations divide the assets into two classes—capital and section 1231 assets and all other assets—and restrict the ability to adjust the basis of the assets both upward and downward among and within classes without IRS approval.[301] Distortions will occur if

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295 I.R.C. § 732(c) (1988).

296 *See id.* § 723 (1988).

297 *Id.* §§ 754; 743(b).

298 This provision will apply to basis adjustments resulting from subsequent acquisitions of partnership interests to which a section 754 election will apply.

299 Section 732(d) provides, in part, that a transferee partner receiving a distribution of property within two years of the transfer of the partnership interest may elect to treat the basis of such property received as if it were determined pursuant to § 743(b). The acquiring partners in a transaction that terminates the partnership pursuant to § 708 will always qualify for this provision.

300 *See* I.R.C. § 197(f)(9)(E) (West 1994).

301 *See generally* Treas. Reg. § 1.755-1(a) (1956). Section 1060 will determine the valuation of individual assets. The individual asset values will then be factored into the classification and allocation process under § 755. *See* Temp. Treas. Reg. § 1.755-2T (1988).

certain assets have depreciated in value while others have appreciated.

Conceptually, the identification and valuation of amortizable section 197 assets will not be affected by the use of the partnership form. However, mechanically, the peculiarities incident to this form of doing business may create distortions. These potential distortions and their effect on the partners should be examined and planned for accordingly.

B. *Effect of Section 197 on Existing and Prospective Agreements*

The consequences resulting from the application of section 197 may potentially reach beyond its effect on the tax liability of the owner of, or partners in, the property. Various agreements that the owner of a property is a party to may be impacted. Moreover, the allocation of cost away from the "bricks and mortar" may have a significant effect on prospective agreements or events.

Agreements that will be impacted by section 197 are those containing provisions that refer to, or depend upon, taxable or financial income for some purpose. Several examples come to mind. Lease terms contain provisions that provide for the landlord to recoup its costs in operating the common area of the mall. These provisions typically provide a formula whereby tenants are charged a portion of the common area costs in proportion to square footage leased.[302] The definition of the costs to be charged will determine whether a portion of the section 197 amortization may be charged to the tenants.[303] If the costs that are chargeable are derived from tax or financial accounting principles,[304] then the

[302] Formulas vary significantly and will generally be determined by the relative bargaining positions of the party. Some formulas may charge a tenant a proportion of costs based on the tenant's square footage in relation to total leased square footage, while others base the proportionate charge on the relationship of the tenant's square footage to leasable square footage. The latter formula forces the landlord to bear a greater share of expenses in the event of vacancies. Other formulas may contain a cap on total charges, inflation adjustments, or may simply provide a flat amount per square foot. Moreover, specific formulas may apply to certain areas of the mall, such as a food court, that are relatively easy to segregate as cost centers.

[303] Only the § 197 assets that relate to the common area should be chargeable to tenants. For example, the amortization of favorable supply relationships and maintenance contracts and a portion of the workforce in place would appear to satisfy this condition while the value of customer-based intangibles would not.

[304] This, of course, assumes that, under generally accepted accounting principles, the financial statements contain a similar allocation of the purchase price to the assets. For financial accounting purposes, the statutory 15 year amortization period would not apply. Independent facts and circumstances would be examined in setting useful lives. *See* Intangible Assets, Accounting Principles Bd. Opinion No. 17 (Ac-

amortization expenses may be recovered. Moreover, this result could affect the setting of minimum rental rates.[305]

Loan covenants are another form of agreement that could be impacted. To the extent the loan covenants require a particular level of taxable or financial income, or establish target financial ratios based on particular classes of assets, the allocation of basis to section 197 assets may affect compliance with, or the degree of freedom from, these covenants. Likewise, an operating covenant with a major tenant may contain similar terms. Employment contracts providing for bonuses based on profitability are another example of agreements that may be impacted by a change in financial or taxable income.

In addition, section 197 may affect the level of real estate taxes assessed against the property. This depends, of course, on the methodology used by the local taxing authorities to set the assessments and the likelihood of successfully appealing such assessments. Finally, section 197 may have a detrimental effect on the ability of a property owner to obtain financing secured solely by the property, although, in theory, section 197 should have no impact on the financing capacity of a particular retail real estate business.[306]

C. *Disposition of the Business*

Section 197 will have several ramifications on the tax consequences of disposing of the retail rental real estate business. For the most part, an allocation of basis to amortizable section 197 intangible assets will have negative implications. Amortizable section 197 assets are treated, for purposes of Chapter 1 of the Internal Revenue Code, as property which is of a character subject to depreciation.[307] The legislative history indicates that amortizable section

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counting Principles Bd. 1970) at ¶¶ 28-29 (limiting, however, the useful life of goodwill to 40 years).

305 An economically rational lessee will examine the total costs of leasing space. To the extent common area charges are increased, downward pressures may be felt on future minimum lease rates. No empirical research was examined to determine whether, in fact, there is a difference in tenants' perceptions of cost depending on what form it takes. In any event, any potential effect on lease rates would not impact existing leases.

306 Section 197 merely identifies and provides special tax rules for assets that already exist. At most, a lender may have to change its procedures for perfecting its security interest. Depending on the applicable state law, certain of the assets may have to be secured under the state's version of the Uniform Commercial Code as intangible assets and the loan documentation will have to be modified accordingly. Of course, in practice, this result may not hold.

307 I.R.C. § 197(f)(7) (West 1994).

197 intangibles are to constitute section 1245 property.[308] As such, the gain realized on disposition of a section 197 asset, to the extent of prior amortization deductions allowed or allowable, will be treated as ordinary income.[309] In contrast, gains from the disposition of real property, are generally characterized entirely as section 1231 gains, eligible for preferential capital gain treatment.[310] The importance of the character of income has been magnified by the tax rate changes in the 1993 legislation.[311]

Generalizations about the effect of this recharacterization should be made cautiously. Whether the loss of preferential tax treatment on a portion of the gain outweighs the benefits of the more rapid periodic deductions will depend on several variables. For example, the time elapsed between purchase and sale, the projected disparity in the tax rates at the time of sale, and the assumed rate of return on available funds will be major determinants of the overall effect of the section 1245 recharacterization.

A second and related consequence resulting from the application of section 197 is a reduction in the possible benefits of the installment method of accounting. In general, the installment method of reporting income allows the seller to recognize income from an installment sale proportionately as payments are received.[312] An installment sale is defined as a "disposition of property where at least [one] payment is to be received after the close of the taxable year in which the disposition occurs."[313] However, sec-

308 Conference Rep., *supra* note 47, at 230. Treas. Reg. § 1.1250-1(e)(3) (1972) defines "real property" for purposes of § 1250. This provision expressly provides for a type of § 1250 asset called "intangible real property." *Id.* It appears that the regulation has in mind traditional "interests in land," such as leases and easements. It is arguable that certain covenants, customer-based intangibles, or other amortizable § 197 assets, should be treated as intangible real property, particularly if state law does not recognize a distinction between the property and certain intangible assets. However, caution should be exercised because this argument may support an assertion by the IRS that the asset in question is an interest in land and, therefore, not a § 197 intangible.

309 *See* I.R.C. § 1245(a) (1988 & Supp. IV 1992).

310 *See id.* § 1250. Section 1250 operates to recapture, as ordinary income, certain amounts of real property depreciation allowed or allowable in excess of a hypothetical straight-line depreciation figure. After 1986, accelerated methods of depreciation were no longer available for real property. As a result, § 1250 is not an issue for realty acquired after 1986. *But see id.* § 291(a) (1988) (providing, in the case of a C corporation, that 20% of the excess of the amount which would have been recaptured under § 1245, had it applied, over the amount of § 1250 recapture is to be treated as ordinary income).

311 *See supra* note 65 and accompanying text.

312 I.R.C. § 453(c) (1988).

313 *Id.* § 453(b)(1).

tion 453(i) precludes the deferral of income that is recaptured as ordinary income pursuant to section 1245. The importance of the installment sales method has been reduced in recent years due to a radical curtailment of its benefits.[314] However, in situations where such method would prove advantageous, section 197 could work to reduce the advantages otherwise available.[315]

Finally, section 197 creates several complexities in the case of a like kind exchange under section 1031. No gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like kind which is to be held for productive use in a trade or business or for investment.[316] If money or property, other than like kind property, is received in the exchange the gain realized on the exchange is recognized to the extent of the amount of money and the fair market value of the other property received.[317]

Whether properties are of like kind is determined based on the nature and character of the property.[318] The existence of section 197 assets that are part of an exchange significantly complicates the application of section 1031. State law generally governs the determination of the nature of the legal interest in question—that is, realty or personalty.[319] It is not entirely clear whether certain section 197 assets may be considered real property under state law.[320] Assuming, however, that section 197 assets will not be considered real property the exchange of a shopping center for property of like kind that carries with it no section 197 intangibles—for example, raw land—will force recognition of the gain attributable to the section 197 intangibles exchanged. This result will occur because a portion of the real property received on the exchange

314 The major impediment to the use of the installment sales method is the imposition of an interest charge on the tax deferred from the use of this method. The interest charge is based on the underpayment rate in effect under § 6621(a)(2). The deferred tax liability to which this rate is imposed is calculated at the maximum rate of tax applicable to ordinary income or capital gain, as the case may be. However, the tax attributable to the profit on $5,000,000 of annual installment sales is, in effect, exempted from the interest charge. *See generally* I.R.C. § 453A(a)-(c) (1988 & Supp. IV 1992).

315 Installment sales treatment may be advantageous in the case where the interest charge imposed by § 453A is less than the seller's cost of funds. This method may also serve as the only source of funds for some sellers.

316 *Id.* § 1031(a)(1).

317 *Id.* § 1031(b).

318 Treas. Reg. § 1.1031(a)-2(b) (1991).

319 *See, e.g.*, Morgan v. Commissioner, 309 U.S. 78 (1940); United States v. Dallas Nat'l Bank, 152 F.2d 582 (5th Cir. 1945).

320 *See supra* notes 259 and 306 and accompanying text.

will be deemed to have been exchanged for the section 197 assets, an exchange not of like kind.

In the event a shopping center is exchanged for another shopping center or other type of property that may carry section 197 intangibles with it, the rules of Treasury Regulation section 1.1031(j)-1 will apply. These rules, of byzantine complexity even by Internal Revenue Code standards, require a grouping of the properties exchanged and received into "exchange groups" and "residual groups."[321] Mechanically, the regulations attempt to group like kind property exchanged and received and, to the extent of a value disparity, allocate other property to balance the exchange. The problem facing a taxpayer is that the regulations categorically deny like kind exchange treatment for goodwill and going concern value.[322] Presumably, this categorical exclusion will be applied to section 197 assets that have traditionally been associated with goodwill and going concern value although the regulations provide language that may support an argument otherwise.[323] Section 1031 is a terrific tax planning device. However, it may be some time before its application in a section 197 environment is routine.

V. CONCLUSION

The acquisition of a retail rental real estate business should be approached in the same manner as the acquisition of other businesses. The due diligence process should seek to identify the existence of intangible assets that may be, and should be, severed from the realty acquired. In turn, the valuation process should appropriately segregate the value inherent in these intangible assets. Dogmatic adherence to existing procedures should be avoided. Whether section 197 will prove to be of significant benefit to an acquirer will be determined based on the facts and circumstances that exist at the time of the acquisition.

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321 *See* Treas. Reg. § 1031(j)-1(b)(2) (1991).

322 *See id.* § 1031(a)-2(c)(2).

323 The regulations do hold out the possibility that certain § 197 intangibles may be exchanged for others of a like kind. The regulations refer, by way of example, to patents and copyrights. *Id.* § 1.1031(a)-2(c)(1). Interestingly, the regulations state that "[w]hether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved . . . and also on the *nature or character of the underlying property to which the intangible personal property relates.*" *Id.* (emphasis added). This language may support an argument that § 197 assets, traditionally associated with goodwill, may qualify for like kind exchange treatment.