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## Internal Revenue Code Section 197: A Cure for the Controversy over the Amortization of Acquired Intangible Assets

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# COMMENTS

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## I. INTRODUCTION

The addition of section 197 to the Internal Revenue Code marks a fundamental change in the federal tax treatment of acquired intangible assets.<sup>1</sup> Section 197 allows the taxpayer to amortize<sup>2</sup> and deduct the cost of most intangibles purchased on or after August 11, 1993<sup>3</sup> and held in connection with the conduct of a trade or business or for the production of income.<sup>4</sup> Goodwill and going concern value are now depreciable for the first time since the days of Prohibition.<sup>5</sup> The amount of the

1. Congress added section 197 of the Internal Revenue Code through enactment of the Omnibus Budget Reconciliation Act of 1993 ("OBRA '93"), Pub. L. No. 103-66, § 13261(a), 107 Stat. 270, 532 (1993) (codified at 26 U.S.C. § 197 (Supp. V 1993)).

2. Amortization is the common way of referring to depreciation of intangible assets. Martin J. Gregorich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 TAX LAW. 251, 253 (1975). The applicable statutes and regulations, however, use only the term depreciation. This Comment will use the terms amortization and depreciation interchangeably when dealing with intangibles.

3. Alternatively, the taxpayer may elect to apply the new intangibles amortization rules to intangible assets acquired on or after July 25, 1991. However, if such election is made, it will apply only to intangibles encompassed by section 197 and not merely the particular assets selected by the taxpayer. OBRA '93, Pub. L. No. 103-66, § 13261(g), 107 Stat. 270, 540 (1993). This provision also contains an "elective binding contract" exception. *Id.*

4. 26 U.S.C. § 197 (Supp. 1993) [hereinafter "I.R.C." replaces "26 U.S.C."].

5. *Id.* Prior to the U.S. Supreme Court's decision in *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670 (1993), goodwill was a per se nonamortizable intangible. However, the Court in *Newark Morning Ledger* diluted the per se rule of nonamortizability by holding that if a

deduction is determined by ratably amortizing the intangible's adjusted basis over fifteen years beginning with the month in which it is acquired regardless of its true economic life.<sup>6</sup>

The legislative, regulatory, and judicial regime for taxing purchased intangibles prior to section 197's enactment not only resulted in substantial uncertainty and dissimilar treatment of similarly situated taxpayers, but also imposed wasteful transaction and administrative costs on taxpayers and the government. Further, this regime fostered expensive litigation over acquisitions involving the purchase of intangibles.<sup>7</sup> Section 197 promises a simple solution to the "legislative, judicial, and regulatory governance of purchase price allocations to intangible assets [which had become] an administrative quagmire and a judicial disaster."<sup>8</sup> However, not all taxpayers welcome the legislative solution to the Sisyphean toil that they often have encountered.

Proponents of section 197 claim that it promotes equal treatment of similarly situated taxpayers through clarification of the tax law on intangibles, thereby enabling more informed and accurate planning and structuring of acquisitions, and reducing the amount of litigation over amortization of acquired intangibles.<sup>9</sup> Opponents maintain that the fif-

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taxpayer was able to prove that an acquired intangible could be valued and had a limited useful life, then it could be amortized over its useful life regardless of how much the intangible asset appeared to "reflect the expectancy of continued patronage"—the commonly accepted definition of goodwill. *Id.* at 1681. Nevertheless, the Court noted that this "burden often [would] prove too great to bear." *Id.* Section 197 and this Comment treat going concern value the same as goodwill insofar as both are now amortizable intangibles. For a thorough discussion 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) (discussing the tax treatment of going-concern value prior to the enactment of section 197).

6. I.R.C. § 197(a).

7. See *Tax Treatment on Intangible Assets: Hearing Before the Committee on Finance, United States Senate, on S. 1245, H.R. 3035, and H.R. 4210*, 102d Cong., 2d Sess. 1, 3 (1992) [hereinafter *Hearings*] (testimony of Hon. Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, Department of the Treasury and former IRS Commissioner).

8. Jon D. Kitchel, *A Tax Policy Analysis of Recent Legislative Proposals Regarding the Treatment of Goodwill*, 58 TAX NOTES 87 (1993) (quoting from summary of Kitchel article, full text found in 92 TAX NOTES TODAY 252-89, Dec. 18, 1992, available in LEXIS, Taxria Library, TNT File). The Second Circuit went so far as to state:

In the realm of intangibles . . . the rulings and decisions are in a state of hopeless confusion . . . . The taxpayer, who may be exposed to interest and penalties for guessing wrong, is entitled to reasonably clear criteria or standards to let him know what his rights and duties are. As matters stand, the following quotation alluded to by a court of appeals of another circuit, which was wrestling with this general area of federal law, is pertinent, "This kind can come forth by nothing, but by prayer and by fasting."

*Briarcliff Candy Corp. v. Commissioner* 475 F.2d 775, 785 (2d Cir. 1973).

9. See generally *Hearings*, *supra* note 7; *Retroactive Intangibles Rules Would Be Windfall For Aggressive Taxpayers, Bar Association Says*, 92 TAX NOTES TODAY 212-47, Oct. 21, 1992, available in LEXIS, Taxria Library, TNT File (letter from the Committee on Taxation of

teen-year amortization period is too arbitrary and should more closely reflect the life of the particular intangible,<sup>10</sup> and that section 197's allowance of an amortization deduction for goodwill and similar intangibles is "a taxpayer subsidy for new mergers and acquisitions activity."<sup>11</sup>

This Comment evaluates section 197 as legislation designed to cure recurring disputes over intangibles between taxpayers and the IRS. Part II provides the background for understanding this necessary piece of intangibles legislation. It first describes the long-standing controversy over acquired intangible assets, explains the crux of both the taxpayers' and the IRS's concerns—the timing of cost recovery and purchase price allocation among acquired intangible assets—and contrasts the legislative evolution of tax rules governing the timing of cost recovery for acquired tangible assets with that of acquired intangibles.

Part II traces the judiciary's search for a workable solution to the intangibles quandary, culminating in the United States Supreme Court decision, *Newark Morning Ledger Co. v. United States*,<sup>12</sup> a decision reached just four months prior to the enactment of section 197. The discussion therein focuses on customer-based intangibles, such as customer lists, insurance expirations, and bank core deposits, and concludes that while the judiciary's attempt to cure the intangibles controversy in the wake of legislative and regulatory neglect was laudable, the remedy was simply a matter better left to the legislature. As a former IRS Commissioner stated succinctly in hearings before the Senate Committee on Finance: "No amount of after the fact enforcement and litigation can possibly remedy [the intangibles] situation. Legislation is essential . . .

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Corporations of the Association of the Bar of the City of New York to Rep. Dan Rostenkowski and Sen. Lloyd Bentsen); Tim Gray, 'Winners and Losers' in *Rosty's Intangibles Bill*, 52 TAX NOTES 982 (1991).

10. See generally *Hearings*, supra note 7; Barbara Kirchheimer, *Courts and Congress Take a Good Look at Goodwill*, 56 TAX NOTES 972 (1992); Glenn F. Mackles, *15-Year Amortization of Purchased Intangible Assets—Some Winners, Some Losers*, 79 J. TAX'N 332 (1993).

11. David S. Hilzenrath, *Congress Targets Clinton Tax Plan: Major Revisions Are Expected*, WASH. POST, Apr. 21, 1993, at F1 (quoting a letter from the Conservative Democratic Forum). See Kirchheimer, supra note 10, at 973 (quoting a letter from Sen. Paul Simon and Sen. Kent Conrad stating that section 197's provisions allowing the amortization of purchased goodwill would "subsidize another round of the merger mania we witnessed during the 1980s"); see also *Hearings*, supra note 7, at 13 (statement of Willie L. Baker, Jr., International Vice President and Director, Public Affairs Department of the United Food and Commercial Workers International Union). Information published by the Internal Revenue Service's Statistics of Income Division reveals that intangible asset values reported by corporations grew from \$45 billion in 1980 to \$262 billion in 1987, largely due to growth in M&A activity. U. S. GENERAL ACCOUNTING OFFICE, TAX POLICY: ISSUES AND POLICY PROPOSALS REGARDING THE TAX TREATMENT OF INTANGIBLE ASSETS 10 (1991) (report to the Joint Committee on Taxation) [hereinafter "GAO REPORT"].

12. 113 S. Ct. 1670 (1993).

to eliminate this source of waste, inefficiency, and controversy.”<sup>13</sup>

Part III describes the legislature’s solution—new code section 197—maps the legislative road to its enactment, and evaluates its likely impact as curative intangibles legislation. Further the tax policy implications of Section 197, including its inherent subsidization of certain acquisition activities and its impact on a regime aimed at “matching” business expenses to revenues to better reflect periodic income, will also be addressed. Attention is focused on section 197’s two key features—a uniform cost recovery method and period for most purchased intangibles and an amortization allowance for acquired goodwill. This Comment concludes that while section 197 has its costs, it should cure the intangibles quandary thereby reducing inequity to taxpayers, uncertainty in tax planning, and administrative costs.

## II. BACKGROUND

### A. *Overview of the Pre-Section 197 Controversy Surrounding the Tax Treatment of Acquired Intangible Assets*

The rash of disputes between taxpayers and the IRS over the timing of cost recovery and the allocation of purchase price to acquired intangible assets catalyzed a legislative response that eventually resulted in the enactment of section 197 to the Internal Revenue Code. Intense controversies frequently arose in the context of business-asset acquisitions.<sup>14</sup>

Due to time value of money concerns, taxpayers/acquirers seek recovery their asset-acquisition expenses as soon as possible. The tax rules governing the timing of cost recovery for acquired tangible assets evolved from an economic life approach to a generally uniform-objective approach.<sup>15</sup> The Code groups depreciable tangible assets into objective classes and assigns a cost recovery method and period.<sup>16</sup> Burdensome facts and circumstances inquiries into the actual economic depreciation of a particular tangible asset were foregone in favor of a statutory cost recovery system. This system not only fosters simplicity through useful life approximations, but also injects a tax subsidy

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13. *Hearings, supra* note 7, at 3 (testimony of Fred T. Goldberg, Jr., Asst. Secretary for Tax Policy, Department of the Treasury).

14. See Lawrence M. Dubin, *Allocation of Costs to, and Amortization of, Intangibles in Business Acquisitions*, 57 TAXES 930, 931 (1979) (noting that tax questions “relating to the allocation of costs to intangible assets and the amortization of such costs are apt to arise in any acquisition of assets in which the tax basis of the acquired assets does not carry over to the acquiring entity.”). Such acquisitions generally include asset purchases, stock purchases followed by a taxable liquidation under I.R.C. § 334, or stock purchases treated as asset acquisitions under I.R.C. § 338.

15. See discussion *infra* part II.B.1(a).

16. See I.R.C. § 168 (Accelerated Cost Recovery System).

whether intended by Congress or not.<sup>17</sup> Taxpayers simply have an incentive to invest in those assets which allow for faster cost recovery.

In contrast to the tax treatment of acquired tangibles, the pre-section 197 tax rules governing the timing of cost recovery for acquired *intangible* assets was based on the individual asset.<sup>18</sup> Amortization deductions depended on the acquirer's ability to establish that the acquired intangible had (1) a limited useful life that could be established with reasonable accuracy and (2) an ascertainable value separate from goodwill, since goodwill was nonamortizable.<sup>19</sup> Taxpayers enabled to leap these hurdles could recover the intangible's cost over its actual useful life through economic depreciation deductions. If not, cost recovery had to be deferred until disposition of the asset or dissolution of the enterprise.<sup>20</sup>

Accurately establishing the useful life of acquired intangibles proved to be a formidable, fact-intensive inquiry.<sup>21</sup> Intangible assets such as patents and copyrights had statutorily defined economic lives over which their costs were recoverable.<sup>22</sup> On the other hand, most intangibles were not granted such definitive tax treatment, thus prompting intangibles acquirers to enlist the help of costly experts. The results were often contradictory and confused.<sup>23</sup>

Demonstrating that an acquired intangible asset had a readily ascertainable value distinct from goodwill proved no less difficult.<sup>24</sup> Generally, if the price paid to acquire a business exceeded the value of its tangible assets, the purchaser had to allocate the excess to nondepreciable goodwill or going concern value, or to other amortizable intangibles.<sup>25</sup> Consequently, taxpayers allocated the cost of borderline amortizable intangibles away from goodwill, and were again forced to enlist the help of experts.<sup>26</sup> The IRS, in response, would often reject the

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17. It is not clear whether Congress intended to create a subsidy. See STAFF OF JOINT COMM. ON TAXATION, PRESENT LAW AND PROPOSALS RELATING TO THE FEDERAL INCOME TAX TREATMENT OF THE COST OF ACQUIRING GOODWILL AND CERTAIN OTHER INTANGIBLES 102D CONG., 2D SESS. 17 n.62 (Jt. Comm. Print 1992) [hereinafter "JCT REPORT 2"] ("In the case of tangible property, the specified lives often were designed to contain an incentive accelerated depreciation element.").

18. See discussion *infra* part II.B.1(b).

19. See Treas. Reg. § 1.167(a)-3 (1993); see also discussion *infra* part II.C.

20. See I.R.C. § 165 and Treas. Reg. § 1.165-2 (1993) (basis of nondepreciable intangibles may be deducted as a loss upon disposition of asset or discontinuation of the firm).

21. See discussion *infra* part II.C.

22. Pre-section 197, the cost of patents were recoverable over a 17-year period, unless the taxpayer established a shorter useful life.

23. See discussion *infra* part II.C.

24. See discussion *infra* part II.C.

25. See discussion *infra* part II.C.

26. See discussion *infra* parts II.B.2. and II.C.

purchase price allocation, maintaining that the claimed depreciable intangible was actually goodwill or another nondepreciable intangible.<sup>27</sup> Oddly, neither the Code nor the Treasury Regulations defined goodwill. Thus courts were forced to attempt to develop and apply a workable standard for resolving tax disputes. The problem, however, was that the intangibles morass needed a rule to supply a firm footing, not an unwieldy standard.

B. *The Timing of Cost Recovery and Purchase Price Allocation—  
The Statutory and Regulatory Framework*

1. THE TIMING OF COST RECOVERY

Since income is taxed on a net basis, a taxpayer's chief concern when acquiring business assets or making other expenditures is the extent of cost recovery permitted by the tax laws and regulations. Costs are recovered through income tax deductions, the value of which are linked to the timing of the deduction. Time value of money principles dictate that the sooner costs can be recovered through a deduction, the more valuable the deduction is to the taxpayer/asset acquirer.

The best of all possible worlds, a current year deduction, is permitted for all ordinary and necessary business expenditures whose benefits currently expire.<sup>28</sup> This facilitates the tax accounting concept of "matching," which dictates that net income shall be determined by matching "revenue earned in the taxable year with expenses properly allocable to the production of that income."<sup>29</sup>

The Code does not, however, allow a current deduction for capital expenditures, which are defined as "amount[s] paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."<sup>30</sup> Capital expenditures are made (or are deemed to have been made) to "aid in the production of income for more than one year,"<sup>31</sup> or "to create or enhance . . . a separate and distinct additional asset,"<sup>32</sup> or otherwise to provide some significant long-term benefit.<sup>33</sup> Capital expenditures must be "capitalized" as costs of the

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27. See discussion *infra* part II.B.2.

28. I.R.C. § 162(a).

29. Gregorich, *supra* note 2, at 252. See I.R.C. § 446(b) (1988) (the allocation of costs must "clearly reflect income"); see also George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179, 1184 n.15 (1987) (questioning whether the financial accounting notion of "matching" leads to an accurate reflection of income and sound tax policy).

30. I.R.C. § 263(a)(1).

31. Gregorich, *supra* note 2, at 252.

32. *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 354 (1971).

33. See generally *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992) (fees incurred by target corporation in the course of a friendly takeover must be capitalized, presumably since a long-term benefit was created in the form of the opportunity for synergy). "[D]ecisive



assets. That is, basis is recovered either through a deduction upon disposition of the asset where no specific asset or useful life can be determined or, more commonly, through accelerated depreciation deductions derived from the accelerated cost recovery method of depreciation ("ACRS") for ACRS assets.<sup>34</sup> Although the timing of cost recovery under a theoretically proper "matching" regime may be desirable, divergence from the "matching" approach is readily identifiable in the tax treatment of capital expenditures. Implicit timing of cost recovery preferences are evident.<sup>35</sup>

There is an overt preference for intangible capital expenditures over tangible capital expenditures.<sup>36</sup> Expenditures incurred to create or increase the value of tangible assets or to prolong their use past the current year must be capitalized.<sup>37</sup> However, many nonacquisitive intangible capital expenditures, such as expenditures on advertising and research and development, incurred to increase the value of or to create new intangible assets are currently deductible.<sup>38</sup>

For example, although advertising expenditures serve the dual purpose of increasing current revenue and promoting long-term goodwill, they may be currently deducted as ordinary and necessary business expenses.<sup>39</sup> Research and development expenditures, although usually "capital," may also be currently expensed.<sup>40</sup> Thus, due to the time value of money, the ability to deduct nonacquisitive intangible capital expenditures currently, "even if matched by an income inclusion in later years, provides the substantial benefit of interest-free use of tax savings" through beneficial "mismatching."<sup>41</sup>

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distinctions' between current expenses and capital expenditures 'are those of degree and not of kind, and that [is] because each case 'turns on its special facts' [—] the cases sometimes appear difficult to harmonize." *Id.* at 86 (citations omitted).

34. See, e.g., I.R.C. §§ 165, 336, 1211 & 1212 (1988 & Supp. V 1993) (governing loss deductions); I.R.C. § 167 (1988 & Supp. V 1993) (depreciation generally); I.R.C. § 168 (1988 & Supp. V 1993) (ACRS depreciation deduction). For non-ACRS assets, economic depreciation deductions may be taken over the useful life of the asset.

35. See Mundstock, *supra* note 29, at 1192-1205.

36. *Id.* at 1193. "'Intangible capital expenditures' are expenditures that increase the amount of intangible capital at the end of the year in which the expenditures are made." *Id.* at 1185.

37. I.R.C. § 263 (1988 & Supp. V 1993).

38. See Mundstock, *supra* note 29, at 1185-86, 1193.

39. Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 HARV. L. REV. 859, 870 (1968) [hereinafter "Harvard Note"]. See Mundstock, *supra* note 29, at 1197 (noting that the IRS generally does not challenge advertising expense deductions).

40. See I.R.C. § 174(a)-(b) (1988) (taxpayer may deduct R&D expenditures in the year incurred or may ratably amortize such expenses over a period not less than 60 months).

41. Robert J. Peroni, *A Policy Critique Of The Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1, 7-8 (1988). Beneficial mismatching may be viewed as a tax shelter driven by the "deferral effect":

Prior to the enactment of section 197, there was a conspicuous, implicit cost recovery preference for tangible asset acquisition expenditures over intangible asset acquisition expenditures. An acquired intangible asset could only be amortized over its economic life—if the life could be established. If an intangible's true economic life was incapable of verification, or if the acquired intangible could not be proven separate or distinct from goodwill, then cost recovery had to be deferred until disposition of the asset or discontinuation of the firm.<sup>42</sup> In contrast, the basis of an acquired tangible asset that qualifies for the ACRS method of depreciation is generally depreciated over an artificial, noneconomic, and usually favorable recovery period.<sup>43</sup> “[B]y providing the taxpayer with deductions in excess of the decline in economic value of the depreciable asset, . . . artificial deductions [are generated] in the early years of a venture in which the ACRS property is used.”<sup>44</sup> The net result of accelerated depreciation is simply a tax subsidy. Thus, beneficial mismatching, or the deferral effect, made acquired tangible assets preferred assets.

a. The Road to a Comprehensive and Uniform System for Depreciating Acquired Tangible Assets

The depreciation deduction has been an integral part of the federal tax system since at least since 1909, “when Congress recognized that a corporation should calculate its annual net income by deducting from gross income ‘all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation<sup>[45]</sup> of property, if any.’ ”<sup>46</sup> The fundamental purpose for a depreciation allowance is “to further the integrity of periodic income

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[T]he typical tax shelter arrangement involves the element of deferral: deductions (usually of an artificial or noneconomic nature) in the early years of the arrangement and taxable income (if at all) in the later years of the arrangement. . . . In effect, this deferral is analogous to an interest-free loan from the government in the amount of the tax savings for the period of the deferral. The benefits of deferral increase as the period of the deferral becomes longer and the taxpayer's highest marginal tax rate rises. If a capital cost is allowed to be immediately expensed, this deferral is equivalent to full tax exemption of the income from the investment.

*Id.* at 7-8. See generally Daniel I. Halperin, *Interest in Disguise: Taxing the “Time Value of Money,”* 95 YALE L.J. 506 (1986) (discussing the impact of the time value of money on the taxation of income).

42. See *supra* note 20.

43. I.R.C. § 168 (ACRS).

44. Peroni, *supra* note 41, at 9.

45. Simply stated, “[d]epreciation is the loss in value over time of a business as a result of the effect of exhaustion, wear, tear, obsolescence, and the like on business.” Mundstock, *supra* note 29, at 1187.

46. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1674 (1993) (quoting *Tariff of 1909*, § 38 Second, 36 Stat. 11, 113).

statements by making a meaningful allocation of the cost entailed in the use . . . of the asset to the periods to which it contributes ["matching"]."<sup>47</sup> But Congress abandoned the theoretically sound matching regime in favor of an objective uniform cost recovery system.

The current acquired tangible asset depreciation rules resulted from intermittent Congressional attention since the inception of the modern tax code in the Revenue Act of 1913.<sup>48</sup> Undeniably, the evolution of the tax treatment of tangibles was prompted not only by concerns of simplicity, uniformity, and administrability, but also by increasing congressional sophistication in providing investment incentives<sup>49</sup> and responding to an IRS and a judiciary ridden with tax disputes over cost recovery of tangible assets.<sup>50</sup> The end result of this legislative progres-

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47. *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104 (1960). The allocation of costs must "clearly reflect income." I.R.C. § 446(b).

48. See GAO REPORT, *supra* note 11, at 16-18. The Tariff Act of 1913 permitted depreciation deductions for the exhaustion, wear and tear of both tangible and intangible assets from their use or employment in the business over their estimated useful lives. Revenue Act of 1913, Pub. L. No. 63-16, § II(B), 38 Stat. 114, 167 (1913). In 1934, the Treasury published regulations requiring taxpayers to justify the useful lives of depreciable assets according to their individual situations. GAO REPORT, *supra* note 11, at 16. In 1942, the Treasury published Bulletin F, which provided depreciation guidelines that included estimated useful lives and depreciation rates for various tangible assets classified by type of industry. *Id.* Congress subsequently liberalized the depreciation provisions by allowing a depreciation deduction for "property held for the production of income." I.R.C. § 167(a)(2). See also Alan S. Schenck, *Depreciation Of Intangible Assets: The Uncertainty of Death and Taxes*, 13 WAYNE L. REV. 501, 505 (1967). In 1962, Bulletin F was replaced by Revenue Procedure 62-21, which was designed to improve taxpayer certainty in determining useful lives and to provide greater uniformity in audits of depreciation deductions by establishing classes of assets with a guideline life for each class. GAO REPORT, *supra* note 11, at 17. In 1971, Congress adopted the Asset Depreciation Range System (ADRS) partly to correct administrative difficulties encountered in useful life determinations. *Id.* The Economic Recovery Tax Act of 1981 added the Accelerated Cost Recovery System (I.R.C. § 168), which allowed cost recovery over predetermined recovery periods fixed by statute rather than the economic useful lives of the tangible assets. S. REP. NO. 144, 97th Cong., 1st Sess. 48 (1981).

49. "Expensing and accelerated capital recovery have generally been enacted to encourage taxpayers to invest in particular categories of assets or to increase overall savings and investment. The result is an allocation of economic resources that is different from what would exist in the absence of such tax incentives, as well as effective tax rates that vary among industries according to the amounts invested in preferred assets." Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549, 556-57 (1985) (citing STAFF OF JOINT COMMITTEE ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 35-40, 75 (Jt. Comm. Print 1982)). ACRS was enacted as a way "of stimulating capital formation, increasing productivity, and improving the nation's competitiveness in international trade." STAFF OF JOINT COMMITTEE ON TAXATION 97TH CONG. 2D SESS. *supra*, at 75. But see Peroni, *supra* note 41, at 9 n.27 (the deferral effect was apparently unintended by Congress since the Staff of the Joint Committee on Taxation receded from its earlier statement of the purpose of the ACRS and subsequently stated that ACRS was meant to establish a system "approximately equivalent to expensing," not more advantageous than expensing) (citing S. REP. NO. 494, 97th Cong., 2d Sess. 126 (1982); accord Warren, *supra*, at 554 n.20 (citing S. REP. NO. 494, 97th Cong., 2d Sess. 122 (1982))).

50. GAO REPORT, *supra* note 11, at 21. See Timothy J. Kenesey, *Simplifying the Tax*

sion permitted taxpayers to depreciate applicable tangible assets under section 167<sup>51</sup> in accordance with the statutory cost recovery system embodied in section 168<sup>52</sup> and the regulations thereunder. Economic depreciation and its individual useful life determinations were augmented by a comprehensive and uniform system for tangible asset depreciation, thus minimizing subjective facts and circumstances inquiries, taxpayer uncertainty, and tax disputes.

b. Statutory and Regulatory Intangibles Neglect—The Stunted Evolution of Acquired Intangibles Amortization Rules

Before the addition of section 197 to the Code, there was a striking difference between the depreciation rules for tangibles and the amortization rules for intangibles.<sup>53</sup> The distinction was primarily due to the Treasury's presumption that most tangible business assets eventually exhaust, wear, tear, deteriorate, or become obsolete, and, therefore have limited and determinable useful lives.<sup>54</sup> Since tangible assets were presumed to possess determinable economic lives, the taxpayer only needed to establish the expected depreciation recovery period. Eventually realizing the uncertainty inherent in an expectations approach, Congress later adopted the uniform approach of a statutory accelerated cost recovery system.

In contrast to the preferential depreciation rules for tangibles, taxpayers who acquired intangible assets held suspect assets. The regulations required the taxpayer to prove an acquired intangible had a determinable useful life before an amortization deduction could be sustained.<sup>55</sup> Taxpayers' amortization efforts were further frustrated by the flat denial of an amortization deduction for goodwill. The retention by Congress and the Treasury of an often fact-intensive economic-life approach for the depreciation of intangibles may have been due to fear

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*Treatment of Intangibles: It's About Time—But Let's Not Forget Computer Software*, 1992 U. ILL. L. REV. 853 (1992) (discussing the pre-section 197 law).

51. I.R.C. § 167(a) provides, "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income."

52. I.R.C. § 168 sets forth the Accelerated Cost Recovery System (ACRS) and provides, "Except as otherwise provided in this section, the depreciation deduction provided by section 167(a) for tangible property shall be determined by using—(1) the applicable depreciation method, (2) the applicable recovery period, and (3) the applicable convention."

53. See Schenk, *supra* note 48, at 502-03 (discussing, *inter alia*, the different treatment accorded tangible and intangible assets with respect to depreciation); see also Gregorich, *supra* note 2, at 254.

54. See Schenk, *supra* note 48, at 502-03.

55. *Id.* at 503.

of abuse.<sup>56</sup> Nevertheless, intangibles amortization rules had been afforded scant legislative and administrative attention altogether.

The original Revenue Act of 1913 ("1913 Act") allowed taxpayers, in computing net income, to deduct a "reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business . . . ."<sup>57</sup> The statute did not qualify the term "property," therefore, taxpayers did not distinguish tangible and intangible property when taking depreciation deductions.

Regulations issued in 1914 explicitly provided that the depreciation deduction authorized by the 1913 Act was based on the cost of "physical property" which depreciates "from wear and tear due to the use to which the property is put."<sup>58</sup> The regulations further stated that "[a]ssets of any character whatever which are not affected by use, wear and tear . . . are not subject to the depreciation allowance . . . ."<sup>59</sup> Goodwill and trademarks were specifically identified as such assets.<sup>60</sup> Patents and copyrights were exempted from the "use, wear and tear" requirement, presumably since the Treasury thought that patents and copyrights were subject to "exhaustion."<sup>61</sup> Thus, prior to the enactment of the Revenue Act of 1918, most acquired intangible assets were per se nonamortizable.

The Revenue Act of 1918 ("1918 Act"), amended the 1913 Act to allow a depreciation deduction on assets subject to exhaustion, wear, tear, or obsolescence<sup>62</sup> through use in a trade or business.<sup>63</sup> The amendment "broadened the depreciation provisions to include intangible assets

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56. Mundstock, *supra* note 29, at 1234. As Professor Mundstock explains:

In the case of tangibles, there is an upper bound on expected value loss: expected physical wear and tear. This gives some comfort that it is possible to police expectations without looking at values. . . . [F]or many intangibles there is no easily verifiable proxy for value that is analogous to tangibles' wear and tear. One simply cannot see goodwill wear out, although it is expected to, and does, lose value. (A business's goodwill holds value due to 'improvements' in the form of current expenditures.) A useful life requirement is the closest analogy to wear and tear expectations for intangibles. This supports the limitation of an expectations approach by adding a useful life requirement.

*Id.*

57. Tariff Act of 1913, Pub. L. No. 63-16, § II(B), 38 Stat. 114, 167 (1913).

58. Treas. Reg. 33, art. 159 (1914).

59. Treas. Reg. 33, art. 162 (1914).

60. Mundstock, *supra* note 29, at 1234-35 n.254 (citing T.D. 2690, 20 Treas. Dec. Int. Rev. 203-05 (1918)).

61. *Id.*

62. Depreciation for obsolescence was allowed due to "congressional concern for post-war obsolescence." Mundstock, *supra* note 29, at 1234-35.

63. Revenue Act of 1918, Pub. L. No. 65-254, § 234(a)(7), 40 Stat. 1057, 1078 (1919).

that do not undergo 'physical exhaustion' by their use in the business."<sup>64</sup> Accordingly, regulations issued under the 1918 Act explicitly acknowledged that acquired intangible assets "may be the subject of a depreciation allowance."<sup>65</sup> Despite the Treasury's broad acceptance of the depreciability of intangibles, goodwill remained nonamortizable, and entitlement to an amortization deduction was qualified by a determinable and limited useful life requirement.<sup>66</sup> Essentially, the frequently insurmountable useful life requirement was a regulatory intangibles proxy for wear and tear that limited the 1918 legislation.<sup>67</sup>

From thereafter until the August 1993 addition of section 197 to the Internal Revenue Code, the rules and standards governing the amortization of acquired intangible assets remained practically unchanged.<sup>68</sup>

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64. Schenk, *supra* note 48, at 504: "While these assets do not physically depreciate because of their use, they may exhaust by their use in the business." *Id.* at 505 (emphasis added).

65. Treas. Reg. 45, art. 163 (1919). The applicable text reads as follows:

*Depreciation of Intangible Property.* — Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. There can be no such allowance in respect of good will, trade-names, trade-marks, trade brands, secret formulae, or processes.

*Id.*

66. *Id.*; Mundstock, *supra* note 29, at 1233-34.

67. *Id.* at 1233-35.

68. From 1919 through 1927, the IRS eased its stance on the nondepreciability of goodwill amid pleas for reform from distillers whose goodwill and other intangible assets (i.e., tradenames) had been rendered worthless by the Prohibition Amendment. The IRS explained:

Article 163 of Regulations 45, for instance, states that "Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance." It is true that this same article states that no such allowance may be made in the case of intangibles of the class now under consideration, and while in general this negative decision is sound, the controlling rule is the one quoted above, and when an item of intangible property falls within that rule it must be dealt with accordingly. . . . when it is demonstrated that the useful life of an intangible is definitely limited, such intangible then becomes a proper subject of depreciation allowance.

T.B.R. 44, 1 C.B. 133, 134-35 (1919). The 1919 regulations were amended to reflect the narrow exception to the general rule. See T.D. 2929, 1 C.B. 133 (1919) (deleting the last sentence of 1918 regulation which disallowed depreciation of goodwill). In 1926, the Eighth Circuit found in *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927), that a malting company could not take a deduction for goodwill lost due to the passage of the Eighteenth Amendment absent a showing that the loss was not part a general loss resulting from the sale of property since "there can be no wear or tear of good will, or exhaustion thereof by use." *Id.* at 633. The regulations were subsequently amended to reflect the Eighth Circuit's decision.

Treasury Regulation section 1.167(a)-3, which provide the only regulatory guidance for amortizing intangibles under I.R.C. section 167, reads 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. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. . . .<sup>69</sup>

Thus, in stark contrast to the evolution of the tax rules for depreciating acquired tangibles, the product of the stunted evolution of intangibles rules before section 197 was a fact-specific standard taking an economic depreciation approach. The unavoidable result of this often subjective approach was disputes over not only the existence of a determinable useful life, but also the nature of the claimed depreciable intangible asset due to an administrative rule prohibiting amortization deductions for goodwill.

## 2. PURCHASE PRICE ALLOCATION PRE-SECTION 197

Since tax rules do not operate in a vacuum, the legislative and administrative neglect of acquired intangible asset amortization rules fostered further disputes upon interaction with the rules governing asset-based purchase price allocations in business acquisitions.

For tax purposes, the sale of a business is treated as the sale of its individual assets rather than the sale of the entity.<sup>70</sup> In an "applicable asset acquisition,"<sup>71</sup> the purchaser and seller must allocate the purchase price among the assets transferred.<sup>72</sup> From a seller's perspective, the

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See T.D. 4055, VI-2 C.B. 63 (1927) (adding to the regulation that: "No deduction for depreciation, including obsolescence, is allowable in respect of good will"). Thereafter, the regulations remained substantially unchanged. See Treas. Reg. § 1.167(a)-3 (1993).

69. Treas. Reg. § 1.167(a)-3.

70. *Williams v. McGowan*, 152 F.2d 570, 572 (2d Cir. 1945).

71. Defined as "any transfer . . . (1) of assets which constitute a trade or business, and (2) with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets." I.R.C. § 1060(c) (1988).

72. I.R.C. § 1060(a) (1988 & Supp. V 1993). Generally, if a mutually agreeable asset allocation is accomplished, the parties are bound by their allocation for tax purposes. John J. Cross III, *Purchase Price Allocations and Amortization of Intangibles*, 209-4th Tax Mgmt. (BNA), U.S. Income Series, A-2 (Jan. 24, 1994) (citing, inter alia, I.R.C. § 1060(a)) [hereinafter *Purchase Price Allocations and Amortization of Intangibles*]; *Danielson v. Commissioner*, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 8589 (1967); *Ullman v. Commissioner*, 264 F.2d

allocation directly affects the amount realized from the sale and the corresponding amount and character of gain or loss recognized.<sup>73</sup> For a purchaser, the allocation establishes the tax basis upon which depreciation or amortization deductions may be taken, if allowed.<sup>74</sup>

According to section 1060(a), for purposes of determining both the purchaser's basis in the assets acquired and the seller's gain or loss from the transfer, the amount allocable is measured by the consideration received for the assets.<sup>75</sup> The amount of consideration (the purchase price) must then be allocated among acquired tangible and intangible assets using the residual allocation method.<sup>76</sup>

Under the residual method, the purchase price is allocated to four prioritized classes of assets according to their fair market values, as follows: (1) first to Class I assets (cash and certain cash equivalents) up to their face amounts;<sup>77</sup> (2) second, after reducing the amount of consideration allocated to Class I assets, to Class II assets (certificates of deposit and marketable securities) to the extent of the fair market value of such assets on their purchase date;<sup>78</sup> (3) third, after reducing the amount of consideration allocated to Class I and II assets, to Class III assets ("all assets (other than Class I, II, and IV assets) both tangible and intangible (whether or not depreciable, depletable, or amortizable), including furniture and fixtures, land, buildings, equipment, accounts receivable, and covenants not to compete") to the extent of the fair market value of such assets on their purchase date;<sup>79</sup> (4) finally, after reducing the amount of consideration allocated to Class I, II, and III assets (hence, the "residual"), to Class IV assets ("intangible assets in the nature of goodwill and going concern value").<sup>80</sup>

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305 (2d Cir. 1959). Not only must the transactional documents indicate the allocation but also the allocation must be grounded in fact and all reporting requirements met. Matthew R. Perkins, *Newark Morning Ledger and Pending Legislation: Their Impact on Acquisitions of Intangibles*, 22 COLO. LAW. 1709 (1993).

73. *Purchase Price Allocations and Amortization of Intangibles*, *supra* note 72, at A-2.

74. *Id.*

75. "The purchaser's consideration is the cost of the assets acquired in the applicable asset acquisition. The seller's consideration is the amount realized from the applicable asset acquisition under section 1001(b)." Treas. Reg. § 1.1060-1T(c).

76. I.R.C. § 1060(a) (requiring allocation to be made "in the same manner as amounts are allocated to assets under section 338(b)(5)," which, in turn, mandates the use of the residual method); *see* Treas. Reg. § 1.1060-1T(a), (d); *see also* *Purchase Price Allocations and Amortization of Intangibles*, *supra* note 72, at A-3. ("Pursuant to Section 338, when a taxpayer makes or is deemed to have made a Section 338 election to treat a qualified stock purchase as an asset purchase for tax purposes, the residual method must be used to allocate the purchase price to the deemed purchased assets.")

77. Treas. Reg. § 1.1060-1T(d)(1) (1993).

78. Treas. Reg. § 1.1060-1T(d)(2)(i) (1993).

79. Treas. Reg. § 1.1060-1T(d)(2)(ii) (1993).

80. Treas. Reg. § 1.1060-1T(d)(iii) (1993).



Thus, under the residual allocation method, the excess of purchase price over the value of Class I, II, and III assets was properly allocated to previously nonamortizable Class IV assets—goodwill and going concern value. Purchasers were therefore highly motivated to allocate as much of the purchase price premium (excess of purchase price over the fair market value of tangible assets) as possible away from goodwill to amortizable intangibles. Consequently, taxpayers became more creative in their efforts to identify amortizable Class III intangibles, arguing that intangibles allocated to Class III had the requisite determinable useful lives, were properly valued and were separate from goodwill.<sup>81</sup> In response, the IRS maintained that much of the purchase price premium allocated to depreciable intangibles belonged in Class IV.<sup>82</sup>

Since goodwill was defined neither in the Code nor in the regulations, the task of resolving many of the resulting disputes over acquired intangibles was left to the courts. This lack of legislative and administrative attention to the acquired intangible asset quagmire caused the judiciary much frustration. Congress and the Treasury Department provided only a naked rule of nonamortizability for goodwill and an economic life standard for determining the amortization of acquired intangibles. The results often proved contradictory and confused—dis-similar tax treatment for similarly situated taxpayers.<sup>83</sup> In other words, the intangibles-amortization regime before section 197 lacked equity, neutrality, and simplicity.

### C. *The Judiciary in Search of a Workable Solution to the Intangibles Quandary*

In the absence of statutory and regulatory development, the law governing the depreciability of intangible assets evolved in the courts. The only statutory and regulatory rules governing the amortization of intangibles were found in Code section 167 and Treasury Regulation 1.167(a)-3. The courts generally read these rules to require proof that a claimed amortizable intangible had (1) an ascertainable value separate

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81. See discussion *infra* part II.C.

82. See discussion *infra* part II.C.; see also GAO REPORT, *supra* note 11, at 3-4 (In 70% of the audited and reported cases in which taxpayers claimed that intangibles had a determinable useful life, the IRS claimed that the assets were nonamortizable goodwill. Based on data gathered in 1989 from all open cases involving acquired intangible asset issues in the examination, appeals, and litigation stages, the IRS proposed adjustments of roughly \$8 billion on the basis of its evaluation of the classification, value, and useful lives of intangible assets.); see also *Purchase Price Allocations and Amortization of Intangibles*, *supra* note 72, at A-3. ("in practical effect, the residual method, [as it was applied before the enactment of Section 197,] focuse[d] attention on finding separate, identifiable intangible assets fitting within the Class III category in order to avoid allocations to [Class IV assets]").

83. See discussion *infra* part II.C.

and distinct from goodwill and (2) a limited and determinable useful life.<sup>84</sup>

Because neither the Code nor the regulations defined goodwill, the courts were left with the task of supplying a definition to create a workable standard. An abundance of case law defined goodwill substantively as an expectancy of value—"the expectancy of continued patronage, for whatever reason."<sup>85</sup> This expansive definition of goodwill engulfed other acquired intangibles which unavoidably derived some, if not all, of their value from the expectation that customers would continue their patronage, but were not denominated "goodwill" by the taxpayer.<sup>86</sup>

As time passed, an increasing number of taxpayers employed valuation engineers and other experts to value acquired intangibles and to establish their wasting character in spite of having some relation to goodwill.<sup>87</sup> In these cases, taxpayers argued that goodwill was merely the residual value that remained after all wasting intangibles that had been "lived and valued" were taken into account.<sup>88</sup> This definition of goodwill, taxpayers maintained, was more consistent with the Code and regulations.<sup>89</sup>

The following discussion examines the ambiguity and inconsistency of court decisions resulting from judicial application of conflicting definitions of goodwill and fact-intensive inquiries to determine the amortizability of acquired intangibles. Disputes over the amortization of customer-based or market-based intangibles, such as core deposits held by financial institutions, insurance expirations, and newspaper and magazine subscription lists, best illustrate the different positions taken by the IRS and by taxpayers; these disputes also help explain the numerous

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84. The basic premise behind the regulation denying an amortization deduction for goodwill was that goodwill was thought to have an indeterminate useful life. See *General Television, Inc. v. United States*, 449 F. Supp. 609, 611 (D. Minn. 1978), *aff'd*, 598 F.2d 1148 (8th Cir. 1979) (per curiam) (goodwill is "presumed to have a useful life of indefinite duration"); see also Gregorcich, *supra* note 2, at 253 ("The regulations thus settle on *limited useful life* as the essential requirement for amortization. Goodwill is viewed as having no ascertainable economic life apart from the business itself, and therefore, as having an indeterminate useful life."); *Harvard Note*, *supra* note 39, at 863 ("Treasury Regulation 1.167(a)-3 . . . denies a [depreciation] deduction for goodwill on the ground that it does not have a determinable useful life estimable with reasonable accuracy.").

85. *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962); see also *Burke v. Canfield*, 121 F.2d 877, 880 (D.C. Cir. 1941) (Goodwill "essentially is constituted in the tendency of customers to return for trade to those with whom they are accustomed to deal."); *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) (Goodwill is the expectancy that "old customers will resort to the old place."); *Des Moines Gas Co. v. Des Moines*, 238 U.S. 153, 165 (1915) (Going concern value is "that element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business.").

86. See discussion *infra* parts II.C.2 and II.C.3.

87. See discussion *infra* parts II.C.2 and II.C.3.

88. See discussion *infra* parts II.C.2 and II.C.3.

89. See discussion *infra* parts II.C.2 and II.C.3.

conflicting court decisions.<sup>90</sup>

# 1. THE "MASS ASSET" DOCTRINE

In a number of cases before 1973 the IRS argued, and the courts applied, the "mass asset" rule (sometimes referred to as "indivisible asset" rule) to deny amortization deductions for acquired customer-based intangibles. Under this doctrine, certain intangibles, such as customer lists, bank deposits and insurance expirations, were deemed components of a single nonwasting or self-regenerating mass asset whose value was inseparable from, and properly allocable to, nonamortizable goodwill and its concomitant, the expectancy of continued patronage.<sup>91</sup>

Judicial application and expression of the mass asset doctrine is best illustrated by *Golden State Towel and Linen Service, Ltd. v. United States*,<sup>92</sup> wherein a taxpayer purchased all of the assets of two of its competitors and sought to capitalize a portion of the purchase price attributable to acquired terminable-at-will customer lists. The Court of Claims invoked the mass asset doctrine to deny a depreciation or loss deduction, stating:

[The taxpayer seeks] an implausible separation of customer lists from goodwill, one a mirror reflection of the other, for goodwill=expectancy of continued patronage=customer lists=goodwill. At least, if goodwill and customer lists are not mutually coextensive, the former includes the latter, and the lesser is inextricable from the greater. In the vernacular, goodwill is a customer list with trimmings. . . . [A] purchased terminable-at-will type of customer list is an indivisible business property with an indefinite, nondepreciable

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90. In cases involving the tax years 1979 to 1987, taxpayers valued the customer-based or market-based intangibles category at \$10.5 billion, making it the largest category of claimed amortizable intangibles. GAO REPORT, *supra* note 11, at 4. On average, these assets were amortized by taxpayers over 8.8 years. *Id.* The IRS's proposed adjustments amounted to some \$4.1 billion. *Id.*

91. JCT REPORT 2, *supra* note 17, at 5. See, e.g., *Danville Press, Inc. v. Commissioner*, 1 B.T.A. 1171, 1172 (1925) (applying mass asset doctrine to disallow amortization deduction with respect to acquired newspaper subscriptions); *Boe v. Commissioner*, 35 T.C. 720, 726 (1961), *aff'd* 307 F.2d 339 (9th Cir. 1962) (denying depreciation or loss deduction for expirable, terminable-at-will medical service contracts on mass asset grounds); *Thoms v. Commissioner*, 50 T.C. 247 (1968) (denying depreciation deduction with respect to acquired list of insurance expirations under mass asset doctrine); *Marsh & McLennan, Inc. v. Commissioner*, 51 T.C. 56 (1968), *aff'd* 420 F.2d 667 (3d Cir. 1969) (same). But see *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646, 652 (9th Cir. 1966) (mass asset rule did not defeat amortization deductions of 70% of purchase price premium allocated to acquired *binding* small loan contracts); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 451 (Ct. Cl. 1976) ("The rationale and purpose of the mass asset rule 'is to prevent taxpayers from increasing the value of depreciable property to offset the amount paid in excess of book value of assets purchased. This doctrine makes it possible to strike down depreciation deductions for amounts which should be properly allocated to good will.'") (quoting *Seaboard Finance Co.*, 367 F.2d at 652).

92. 373 F.2d 938 (Ct. Cl. 1967).

life, indistinguishable from—and the principal element of—goodwill, whose ultimate value lies in the expectancy of continued patronage through public acceptance. It is subject to temporary attrition as well as expansion through departure of some customers, acquisition of others, and increase or decrease in the requirements of individual customers. A normal turnover of customers represents merely the ebb and flow of a continuing property status in this species, and does not within ordinary limits give rise to the right to deduct for tax purposes the loss of individual customers. The whole is equal to the sum of its fluctuating parts at any given time, but each individual part enjoys no separate capital standing independent of the whole, for its disappearance affects but does not interrupt or destroy the continued existence of the whole.<sup>93</sup>

## 2. *HOUSTON CHRONICLE PUBLISHING CO. V. UNITED STATES*

The mass asset doctrine was purportedly laid to rest in 1973 when the Fifth Circuit Court of Appeals, in *Houston Chronicle Publishing Co. v. United States*,<sup>94</sup> rejected a per se rule of nonamortizability in cases involving the acquisition of goodwill with other intangible assets.<sup>95</sup> In *Houston Chronicle*, the taxpayer acquired newspaper subscription lists as part of the acquisition of a newspaper publishing company. The taxpayer had no intention of continuing to operate the acquired publishing company, and consequently maintained that (1) the subscription lists were wasting assets whose value was limited to the extent that they furnished names and addresses of prospective subscribers, and (2) the lists had a reasonably ascertainable useful life of five years.<sup>96</sup> The IRS disagreed, asserting that while the subscription lists may be wasting assets whose value could be estimated with reasonable accuracy, they were, nevertheless, nonamortizable as a matter of law since they were in the nature of goodwill.<sup>97</sup>

The court recognized the force of the IRS's argument, stating that the "proposition [that goodwill is nonamortizable] is so well settled that the only question litigated in recent years . . . is whether a particular asset is 'goodwill.'"<sup>98</sup> However, the court refused to read section 167 and Treasury Regulation 1.167(a)-3 together as a per se prohibition of amortization deductions for acquired intangibles whenever their value

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93. *Id.* at 942-44 (citation omitted).

94. 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

95. *But see* *Ithaca Indus., Inc., v. Commissioner*, 17 F.3d 684 (4th Cir.) (marking an isolated resurrection of the mass asset rule in the context of assembled workforce intangibles), *cert. denied*, 115 S. Ct. 83 (1994).

96. *Id.* at 1244-45.

97. *Id.* at 1245.

98. *Id.* at 1247.

was related to goodwill.<sup>99</sup> Instead, the court held that "the 'mass asset' rule does not prevent taking an amortization deduction if the taxpayer properly carries his dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy."<sup>100</sup> The court commented that "[m]ost of the cases purporting to apply the 'mass asset' rule involve[d] *evidentiary failures* on the part of the taxpayer" to meet the dual burden of proof,<sup>101</sup> because so few taxpayers had obtained favorable findings in similar cases, there was a "paucity of reported cases discussing the level of evidence [needed to] be surpassed if a favorable finding [were] to withstand appellate review."<sup>102</sup> Nevertheless, the court found that the taxpayer's testimony, much of which was expert testimony, "[rose] above the level of 'unsupported opinion of the taxpayer' " and thus met the requirements of Treasury Regulation 1.167(a)-3.<sup>103</sup>

Although *Houston Chronicle* marked a rejection of an absolute "mass asset" rule, it did not entirely extinguish the doctrine. While the court did place particular emphasis on those facts which established the value and useful life of the customer lists,<sup>104</sup> it failed to discuss the relevance of having value "separate and distinct from goodwill."<sup>105</sup> Consequently, taxpayers viewed the decision as standing for the broad proposition that entitlement to an amortization deduction hinged on proving that a claimed amortizable intangible had a wasting life and an ascertainable direct (as opposed to residual) value. The IRS, on the other hand, viewed *Houston Chronicle* as merely a narrow limitation of the "mass asset" doctrine.

In Revenue Ruling 74-456<sup>106</sup> the IRS stated that customer lists and similar intangibles generally represented the customer structure of a business, were in the nature of goodwill, and hence, were nonamortizable.<sup>107</sup> The ruling also stated that if in an unusual case an intangible

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99. *Id.* at 1250.

100. *Id.*

101. *Id.* at 1249 (emphasis added).

102. *Id.* at 1252.

103. *Id.* at 1253 (quoting Treas. Reg. § 1.167(a)-3).

104. *Id.* at 1254 n.9.

105. See *AmSouth Bancorporation v. United States*, 681 F. Supp. 698, (N.D. Ala. 1988), wherein the court stated, "while the [*Houston Chronicle*] court arguably rejected the so called 'mass asset' or 'individual asset' analysis if applied as a *per se* rule, it did so in the context that the total issue is one of fact." *Id.* at 713 n.47. What *Houston Chronicle* did not eliminate was "the necessity to inquire into the issue of 'separate and distinct.' There seems to have been no clear cut repudiation of the 'mass asset' doctrine as a factual consideration; only a recognition that it is not the alpha and omega of the inquiry or a *per se* legal issue." *Id.* at 720.

106. 1974-2 C.B. 65.

107. *Id.* at 66.

asset did not possess the characteristics of goodwill, was susceptible of valuation, and was of use to the taxpayer in its trade or business for a limited period of time, then an amortization deduction could be taken.<sup>108</sup> Thus, the IRS maintained that despite the taxpayer's ability to prove that a claimed amortizable intangible had a wasting life and an ascertainable value, there remained a *virtually per se* rule of nonamortizability for acquired intangibles related to, or in the nature of, goodwill.

### 3. THE JUDICIAL RESPONSE TO *HOUSTON CHRONICLE*—CUSTOMER-BASED INTANGIBLES AS CATALYST FOR LEGISLATIVE INTANGIBLES REFORM

After 1973, the case law reveals judicial confusion and inconsistency over the proper standard to apply when evaluating the amortizability of customer-based intangibles. While the courts acknowledged that entitlement to amortization deductions for intangibles not allocated to goodwill should be determined according to the taxpayer's individual facts and circumstances, *Houston Chronicle* provided little guidance on how taxpayers could extricate the claimed depreciable intangible from nondepreciable goodwill. Consequently, different courts imposed different requirements on taxpayers to establish the existence of an amortizable wasting intangible asset.

In some cases the courts sided with the taxpayer's general interpretation of *Houston Chronicle* and permitted amortization deductions upon the showing that the acquired intangible was capable of direct valuation and had a limited useful life.<sup>109</sup> In other cases, courts also required taxpayers to establish that the same wasting intangible was in fact separate and distinct from goodwill—that its value was not *associated* with the expectancy of continued patronage.<sup>110</sup> Still other courts denied amortization deductions for the same type of intangible, suggesting that if the taxpayer had offered better statistical evidence on the asset's useful life, an amortization deduction may have been allowed.<sup>111</sup>

Thus, despite the IRS's abandonment of an *absolute* "mass asset" rule, the outcome of most cases continued to rest largely on the sophistication of the taxpayer's proof.<sup>112</sup> Conflicting court decisions in the area

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108. *Id.*

109. See discussion *infra* part II.C.3.

110. See discussion *infra* part II.C.3.

111. See discussion *infra* part II.C.3.

112. New York State Bar Ass'n Tax Section, *Report on Proposed Legislation on Amortization of Intangibles* (H.R. 3035), 53 TAX NOTES 943, 946 (1991) [hereinafter "NYSBR"]. Interestingly, based on a survey of 112 intangibles amortization cases taken primarily from cases litigated between 1960 and 1991, before *Houston Chronicle* the IRS won 74% of its intangibles amortization cases. *Id.* After *Houston Chronicle*, the IRS won 60% of such cases. *Id.* In the area of customer list, the IRS won 60% of its cases before 1973, but only 30% since. *Id.* See James T.

of customer-based intangibles reveal the judiciary's struggle for a workable standard that would end the dissimilar tax treatment of similarly situated taxpayers.

a. Insurance Expirations

Various courts have considered the amortizability of acquired insurance expirations and have arrived at conflicting decisions.<sup>113</sup> In *Richard S. Miller & Sons, Inc. v. United States*,<sup>114</sup> the Court of Claims allowed the amortization of insurance expirations acquired as part of the purchase of an insurance agency upon finding that the taxpayer satisfied its burden of proving that the expirations constituted a wasting mass asset with a determinable useful life and an ascertainable value separate and distinct from goodwill.<sup>115</sup>

Consistent with *Houston Chronicle*, the court dismissed the notion of a per se rule of nonamortizability for the expirations.<sup>116</sup> The court acknowledged that the insurance expirations constituted a "mass asset" whose useful life had to be "determined from the facts relative to the whole, and not from experience with any particular policy or account involved."<sup>117</sup> However, the court also noted that the "mass asset" doctrine did not prohibit an amortization deduction "where the expirations as a single asset [could] be valued separately and the requisite showing made that the useful life of the information contained in the intangible asset as a whole [was] of limited duration."<sup>118</sup> Therefore, under the court's reading of *Houston Chronicle*, the taxpayer needed only to establish that the expirations had a limited useful life and a direct value in order to be deemed separate and apart from goodwill, and thus amortizable.

The taxpayer satisfied its burden by proving that the package of expirations was a valuable wasting asset. The court accepted the argument that the expirations were a proxy for the time and effort needed to develop a comparable number of policies for the first time. Therefore,

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Varnadoe, *Recent TC Decisions on Core Deposit Amortization Contain Inconsistencies*, J. BANK TAX'N, Spring 1993, at 19 (valuation expert examines the valuation methods employed by taxpayers in bank core deposit intangibles cases).

113. Insurance expirations are the records maintained by insurance companies with respect to insurance customers and generally include information on the types, amounts, and expiration dates of insurance policies. An insurance expiration's "principal value is its indication of the most advantageous time to solicit a renewal." *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 450 (Ct. Cl. 1976).

114. 537 F.2d 446 (Ct. Cl. 1976).

115. *Id.* at 450.

116. *Id.* at 452.

117. *Id.* at 454.

118. *Id.* at 452.

"[i]n the realities of modern business technology, the expirations represented an intangible asset with an existence separate from other elements of goodwill."<sup>119</sup>

Other courts, however, did not adhere to the Court of Claims reading of *Houston Chronicle*. For example, in *Decker v. Commissioner*<sup>120</sup> the Seventh Circuit affirmed a Tax Court decision disallowing the amortization of the cost of acquired insurance expirations on grounds that the insurance expirations were inextricably linked to goodwill.<sup>121</sup>

Arguably, the dissimilarity in the Seventh Circuit's decision in *Decker* and the Court of Claims' decision in *Richard S. Miller & Sons* was due to the fact that the taxpayer in *Decker* continued the operation of the acquired insurance agency with little change. The *Decker* court may simply have been persuaded that the intangible was, by definition, inextricably linked to nonamortizable goodwill.<sup>122</sup> As one commentator noted, however, a survey of 123 intangibles cases revealed that "the majority of taxpayer victories came in cases in which the amortizable intangible was purchased as part of a going concern."<sup>123</sup> It is therefore doubtful that the distinction between the two cases lies in the fact that one involved the acquisition of a going concern.<sup>124</sup>

Although a simple resolution of these cases does not exist, the most plausible explanation for the difference is that the courts placed different emphasis on the requirement of establishing value "separate and distinct from goodwill"—an issue unaddressed in *Houston Chronicle*. In *Richard S. Miller & Sons*, the court implicitly defined goodwill as a residual, namely, what is left after allocating *wasting intangibles* elsewhere. If a wasting intangible could be directly valued, then it was not part of the residual and was therefore amortizable. On the other hand, the *Decker*

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119. *Id.* at 454.

120. 864 F.2d 51 (7th Cir. 1988).

121. *Id.* at 52-53.

122. Reuven S. Avi-Yonah, Newark Morning Ledger: *A Threat to the Amortizability of Acquired Intangibles*, 57 TAX NOTES 981, 983 (1992).

123. *Id.* at 984.

124. The IRS's stance on the amortizability of intangibles acquired in the purchase of an ongoing business was later clarified in an Industry Specialization Program coordinated issue paper issued by the IRS on January 30, 1990. The IRS paper reviewed a number of court decisions and prior IRS pronouncements dealing with the amortization of customer-based intangibles and concluded:

[W]here an ongoing business is acquired with the expectation of continued patronage of the seller's customer such that the purchaser merely steps into the shoes of the seller . . . [or,] if the customer based intangible represents the customer structures of the acquired business, and that business possesses characteristics of goodwill, then the intangible is inseparable from goodwill, and thus, is nonamortizable as a matter of law.

Internal Revenue Service, *ISP Coordinated Issue Paper on Customer-Based Intangibles*, 91 TAX NOTES TODAY 68-20, Mar. 27, 1991, available in LEXIS, Taxria Library, TNT File.



court implicitly labeled as nonamortizable goodwill any acquired intangible whose value was *associated* with the residual—the expectancy of continued patronage, for whatever reason.

b. Bank Core Deposits

The tax treatment of acquired core deposit intangible ("CDI") assets also highlights the inconsistency in court decisions.<sup>125</sup> For example, in *Colorado National Bankshares, Inc. v. Commissioner*<sup>126</sup> and *Citizens & Southern Corp. v. Commissioner*,<sup>127</sup> which were affirmed on appeal by the Tenth and Eleventh Circuit Courts of Appeals, respectively, the courts permitted the taxpayers to amortize the cost of acquired CDIs.

In both cases, the Commissioner argued that the value of the CDIs was inextricably related to the value of the taxpayers' expectations that depositors would continue to patronize the bank—that is, to goodwill. The Tax Court rejected the IRS's position, clearly espousing the view that any intangible asset that could be "lived and valued" was, by definition, not goodwill:

Goodwill, by definition, has an indefinite life and is valued using the residual method. By contrast, the deposit accounts of the acquired banks could be, and were, identified; had limited lives that could be estimated with reasonable accuracy . . . ; and could be, and have been, valued directly with a fair degree of accuracy. Moreover, petitioner's deposit accounts were not self regenerating. Therefore, the deposit accounts were assets with values separate and apart from goodwill. It is these characteristics which separate them from general goodwill and permits separate valuation.<sup>128</sup>

In affirming *Colorado National*, the Tenth Circuit recognized that the amortizability of the CDIs hinged on the particular definition of goodwill applied. The court accepted the Tax Court's residual approach to defining and calculating goodwill, but voiced its frustration with having to evaluate the boundaries of goodwill, stating:

[N]either the IRS, the Treasury Department, nor Congress have promulgated a specific and uniform definition of goodwill. Although

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125. Core deposits are deposit liabilities that carry either no or low interest. *Colorado Nat'l Bankshares, Inc. v. Commissioner*, 984 F.2d 383, 384 (10th Cir. 1993). A bank may reinvest (lend) core deposits at higher rates of interest than those paid to account holders, and thus realize income through the interest rate spread. *Id.* As an acquired intangible, a CDI represents "the present value of the [expected] future stream of income to be derived from employing the purchased core deposits of a bank." *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463, 465 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

126. 60 T.C.M. (CCH) 771 (1990), *aff'd*, 984 F.2d 383 (10th Cir. 1993).

127. 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

128. *Colorado Nat'l*, 60 T.C.M. (CCH) at 789 (citation omitted).

case law establishes that goodwill constitutes 'the expectancy of continued patronage, for whatever reason,' this amorphous and general definition provides little practical guidance to taxpayers and courts asked to define the parameters of the amortization deduction.<sup>129</sup>

Other courts, however, arrived at holdings directly at odds with *Citizens & Southern* and *Colorado National* by accepting the IRS's expansive approach to calculating and defining goodwill. For example, in *AmSouth Bancorporation v. United States*,<sup>130</sup> the court considered whether the value assigned to acquired CDIs was amortizable. It held that although the CDIs were identifiable, any value created by the expectation that they would continue was not value separate and distinct from goodwill. Consequently, no amortization deductions were allowed.<sup>131</sup>

### c. Subscriptions/Customer Lists/At-Will Contracts

Court decisions on the proper tax treatment for acquired subscription lists were also markedly inconsistent. For example, in *General Television, Inc. v. United States*,<sup>132</sup> the taxpayer acquired two community antenna television (CATV) stations. Among the assets purchased were approximately 7000 terminable-at-will subscriber contracts, which the taxpayer allocated away from goodwill and sought to amortize as wasting intangible assets.<sup>133</sup> The court viewed the subscriber contracts as subscription or customer lists and disallowed amortization deductions on the grounds that the purchase of the at-will contracts was actually the purchase of "customer structures which included the expectancy of continued patronage . . . the essence of [nonamortizable] goodwill."<sup>134</sup>

However, in *Donrey, Inc. v. United States*<sup>135</sup> the Eighth Circuit Court of Appeals upheld the taxpayer's amortization deduction for acquired newspaper subscription lists. Donrey purchased the *Washington Herald Times* and continued its publication.<sup>136</sup> Thereafter, Donrey claimed amortization deductions for a portion of the purchase price allocated to the acquired subscription lists.<sup>137</sup>

The IRS contended that the value of the lists was inextricably linked to goodwill and was therefore nonamortizable as a matter of law.<sup>138</sup> The court disagreed, finding the amortization allowance for an

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129. *Colorado Nat'l*, 984 F.2d at 386.

130. 681 F. Supp. 698 (N.D. Ala. 1988).

131. *Id.* at 719.

132. 449 F. Supp. 609 (D. Minn. 1978), *aff'd*, 598 F.2d 1148 (8th Cir. 1979) (per curiam).

133. *Id.* at 610.

134. *Id.* at 612.

135. 809 F.2d 534 (8th Cir. 1987).

136. *Id.* at 535.

137. *Id.*

138. *Id.*

acquired intangible asset to be a question of fact.<sup>139</sup> Relying on the conclusions reached in *Houston Chronicle*—that the components of a newspaper's customer structure *could be* separately valued, distinguished from goodwill and shown to have a limited useful life—the court allowed the jury verdict, finding that these facts had been established, to stand despite the lower court's comment that if it had been the trier of fact, it would have found the subscription lists nonamortizable.<sup>140</sup>

While *Donrey* emphasized that the amortizability of acquired subscription lists remained properly a question of fact, it failed to offer any analysis on the essence of the dispute—the definition and allocation of goodwill. However, in *Newark Morning Ledger Co. v. United States*,<sup>141</sup> a case which ultimately reached the United States Supreme Court, a federal district court tackled the definitional issue head-on when presented with facts similar to those presented in *Donrey*.

*i. Newark Morning Ledger Co. v. United States*

As the result of a 1987 merger, Newark Morning Ledger Co., a newspaper publisher, became the successor corporation to another newspaper publisher, the Herald Company ("Herald").<sup>142</sup> In 1976, Herald had purchased substantially all of the stock of Booth Newspapers, Inc. ("Booth"), who published and distributed newspapers in eight Michigan communities.<sup>143</sup>

In 1977, Booth merged into Herald pursuant to sections 332 and 334(b)(2) of the Internal Revenue Code of 1954. These rules required Herald to allocate its \$328 million adjusted tax basis in Booth's stock among Booth's assets in proportion to their fair market value at the time of the merger. Of this \$328 million, Herald allocated \$234 million to various financial and tangible assets, \$26.2 million to going concern value and goodwill, and \$67.8 million to an intangible asset denominated "paid subscribers."<sup>144</sup> This intangible consisted of a list of some 460,000 paid subscribers to the eight Booth newspapers. Herald then tried to amortize and deduct the \$67.8 million allocation to "paid subscribers" over the expected useful lives of Booth's subscription lists,

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139. *Id.* at 536.

140. *Id.* at 536-37. See also *Panichi v. United States*, 834 F.2d 300, 302 (2d Cir. 1987) (allowing amortization deductions for cost of acquired list of trash collection customers).

141. 734 F. Supp. 176 (D.N.J. 1990), *rev'd*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993).

142. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1672 (1993).

143. *Id.*

144. *Id.* at 1672-73. The \$67.8 million figure was arrived at by estimating future profits to be derived from at-will paid subscribers to Booth's eight newspapers, assuming all or most of the subscribers would continue to subscribe after the Herald acquisition. *Id.*

enlisting the help of experts in the process.<sup>145</sup> The IRS disallowed the deductions on the ground that a customer-based intangible like “paid subscribers” was indistinguishable from goodwill and therefore nonamortizable under the Code and regulations.<sup>146</sup>

In 1987, Herald was merged into Newark Morning Ledger, which then filed a claim for refund of the additional taxes paid by Herald due to the IRS’s denial of the claimed amortization deductions. The IRS failed to act on the claim and Newark Morning Ledger brought suit for refund in the United States District Court for the District of New Jersey.<sup>147</sup>

a. The District Court

Consistent with *Houston Chronicle*, Newark Morning Ledger argued at trial that to amortize the acquired subscription lists, it needed only to prove that (1) “paid subscribers” was a wasting intangible whose life could be estimated with reasonable accuracy and (2) the intangible had an ascertainable value separate and distinct from goodwill.<sup>148</sup> Newark Morning Ledger proffered, and the IRS stipulated to, statistical evidence showing that “paid subscribers” had a limited useful life and an ascertainable value derived by the income method of valuation.<sup>149</sup>

The IRS, however, argued that Newark Morning Ledger had not overcome the essential hurdle to such amortization deductions—that in addition to establishing a useful life and a direct value, the taxpayer was required to prove that the intangible asset was not goodwill.<sup>150</sup> The IRS viewed the income expected to be generated from the at-will subscribers as value associated with the expectancy of continued patronage, and, as such, not separate and apart from nondepreciable goodwill. In essence, the IRS maintained that while the residual method was appropriate for valuing goodwill, it was unsuitable for defining when an intangible constituted goodwill.<sup>151</sup>

The district court rejected the IRS’s argument and allowed Newark Morning Ledger’s amortization deductions upon finding that it had satisfied the dual burden of proving that the subscription lists had (1) limited

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145. *Id.* Herald amortized the value of the subscription lists on a straight-line basis over their respective estimated useful lives, which ranged from 14.7 to 23.4 years. *Id.* at 1673.

146. *Id.* at 1673.

147. *Id.*

148. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 180 (D.N.J. 1990).

149. *Id.* at 179-83. See George Brode, Jr., *Structuring Taxable Acquisitions of Intangibles Under Section 197*, 60 TAX NOTES 1011, 1013 (1993) (the income approach “analyzes the present value of future cash flows that an asset is expected to generate over its remaining life”).

150. 734 F. Supp. at 179.

151. *Newark Morning Ledger Co. v. United States*, 945 F.2d 555, 559-60 (3rd Cir. 1991).

useful lives that could be estimated with reasonable accuracy, and (2) an ascertainable value separate and distinct from goodwill.<sup>152</sup> In so holding, the court clearly adopted the view that any wasting intangible that could be directly valued was not goodwill and was therefore amortizable.

Goodwill, by definition, has an indefinite useful life and is valued using the residual method. By contrast, the paid subscribers . . . could be, and were, identified; had limited lives that could be estimated with reasonable accuracy; and could be, and herein have been, valued directly. Moreover, the paid subscribers . . . were not self-regenerating. Therefore, [the subscription lists] were assets with values separate and apart from goodwill.<sup>153</sup>

#### b. The Third Circuit Court of Appeals

On appeal, the IRS argued that the lower court improperly defined goodwill as a mere residual and that Newark Morning Ledger's amortization deductions should have been denied because, notwithstanding that the claimed intangibles had ascertainable wasting lives and values, it had failed to establish that "paid subscribers" had a value "separate and distinct from goodwill."<sup>154</sup>

In response, Newark Morning Ledger argued that the lower court employed the proper definition of goodwill—that goodwill was no more than the residual value that remains after accounting for all wasting intangibles with ascertainable direct values.<sup>155</sup> Thus, the taxpayer maintained that any acquired intangible capable of being "lived and valued" was not goodwill.

The Third Circuit agreed with the IRS and reversed the district court. It refused to follow the Eighth Circuit's deference to the factfinder in *Donrey*, and rejected Newark Morning Ledger's residual definition of goodwill. The court stated that under Newark Morning Ledger's proffered definition, the regulatory requirement "that an intangible asset be shown to have value 'separate and distinct from goodwill' adds nothing to the undisputably satisfied requirement that the taxpayer demonstrate that the asset has a limited useful life and provide a reasonably accurate estimate of that life."<sup>156</sup>

Further, the court found that Newark Morning Ledger's position,

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152. 734 F.Supp. at 185.

153. *Id.* at 182-83.

154. 945 F.2d at 558-59.

155. *Id.* at 560.

156. *Id.*

while supported by some cases,<sup>157</sup> represented “no more than a minority strand amid the phalanx of cases” that have adopted the IRS’s view that goodwill has a substantive meaning—the expectancy of continued patronage.<sup>158</sup> Applying the IRS’s nonresidual definition of goodwill, the court concluded that Newark Morning Ledger had not satisfied its burden of proving that the value of the wasting subscription lists was separate and distinct from goodwill. Consequently, it disallowed amortization deductions.<sup>159</sup> Newark Morning Ledger subsequently filed a petition for a writ of certiorari to the United States Supreme Court.

c. The United States Supreme Court

The law governing the amortization of acquired intangibles both before and after the Third Circuit’s decision was unclear and conflicting. Many cases dealt with amortization of the same intangible and most used the *Houston Chronicle* analysis, but none of the results could be predicted with any reasonable degree of certainty. The cases showed that similarly situated taxpayers could be subjected to dissimilar tax treatment based on the sophistication of their representation and expert witnesses and the state of the law in their particular forum. In an effort to resolve this conflict and ambiguity, the Supreme Court granted Newark Morning Ledger’s petition for certiorari.<sup>160</sup>

In a five to four decision, the Supreme Court reversed the Third Circuit and held that “a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage.”<sup>161</sup>

The majority found the IRS’s definition of goodwill to be “of little

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157. See, e.g., *Colorado Nat’l, Citizens & Southern, Donrey, Houston Chronicle*, and *Richard S. Miller & Sons*.

158. 945 F.2d at 565-66 (citing, *inter alia*, *AmSouth, General Television, Decker, Golden State Towel, Boe*, and *Houston Chronicle*).

159. *Id.* at 568. Despite its acceptance of the IRS’s argument, the court noted critically that:

[T]he governing regulations have prohibited the depreciation of goodwill for over sixty years. During that time, the meaning of the term ‘goodwill’ has been litigated repeatedly, and often with high stakes, as taxpayers attempt to minimize the tax burden associated with purchased intangible assets by minimizing the amount of the purchase price allocated to nondepreciable goodwill. Despite the recurrence of the issue, neither Congress, the Treasury, nor the Service has seen fit to promulgate a uniform or coherent definition of the term. Rather, the Service apparently has been content to permit the courts to wrestle, case-by-case, with the contours of this elusive concept, with the result that it wins most cases because the taxpayer cannot sustain the onerous burden of establishing value and determinable life.

*Id.* at 559 n.5 (citation omitted).

160. *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1674 (1993).

161. *Id.* at 1681.

assistance to a taxpayer trying to evaluate which of its intangible assets [were] subject to a depreciation allowance [since the] value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will continue their patronage.”<sup>162</sup> Convinced that the only reason for the prohibition against amortizing goodwill was that it had an indeterminate useful life, the Court concluded that the “significant question for purposes of depreciation is not whether the asset falls ‘within the core of the concept of goodwill,’ but whether the asset is capable of being valued and whether that value diminishes over time.”<sup>163</sup> Accepting a residual definition for goodwill was, in the Court’s view, “more faithful” to the Code because “ ‘the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.’ ”<sup>164</sup>

The four dissenting justices vigorously contested the majority’s implicit acceptance of the residual definition of goodwill, stating:

[Newark Morning Ledger] would have us scrap the accepted and substantive definition of ‘goodwill’ as an expectation of continued patronage, in favor of a concept of goodwill as a residual asset of ineffable quality, whose existence and value would be represented by any portion of a business’s purchase price not attributable to identifiable assets with determinate lives. Goodwill would shrink to an accounting leftover.<sup>165</sup>

The dissenters also disputed the majority’s contention that its approach was more faithful to the Code’s goal of matching, stating “[s]uch policy initiatives are properly left to Congress, which can modify the *per se* ban on depreciating goodwill at any time.”<sup>166</sup> The majority was simply unpersuaded by this argument since, in its view “[t]he entire justification for refusing to permit the depreciation of goodwill evaporates, however, when the taxpayer demonstrates that the asset in question wastes over an ascertainable period of time.”<sup>167</sup>

Although the end result of the decision was a clarification of *Houston Chronicle*’s two-prong factual standard, the Court was careful not to imply that the taxpayer’s burden of proving the life and value of a wasting intangible was insignificant. The Court generally agreed with the Third Circuit’s observation that in “the context of the sale of a going concern, it is simply too difficult for the taxpayer and the court to sepa-

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162. *Id.* at 1675-76.

163. *Id.* at 1681.

164. *Id.* at 1680 (quoting *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992)).

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

166. *Id.* at 1689 n.10 (Souter, J., dissenting).

167. *Id.* at 1680.

rate the value of the list *qua* list from the goodwill value of the customer relationships/structure.”<sup>168</sup> Nevertheless, the Court noted that “sometimes they manage to do it.”<sup>169</sup>

The precedential value of *Newark Morning Ledger* was rather limited. Not only was it a five to four decision, but the IRS erred by not contesting the taxpayer’s expert evidence and by stipulating to the useful life estimates of “paid subscribers.”<sup>170</sup> The IRS certainly would not maintain the same litigation strategy in future contested matters.<sup>171</sup> Moreover, while *Newark Morning Ledger* clarified the legal issue—that certain intangibles such as customer lists may sometimes qualify for amortization despite their association with the expectancy of continued patronage—the factual hurdle remained. Subsequent cases would still turn on the factual questions of whether the taxpayer could prove that an acquired intangible asset had an ascertainable value and a limited useful life—a burden the Court said “often will prove too great to bear.”<sup>172</sup> Absent some sort of legislation, these factual issues and the resulting disputes were likely to remain.

It therefore behooved Congress to adopt a legislative solution to the inevitable and continuing disputes over the amortization of intangible assets that would produce consistent results for similarly situated taxpayers. Congress’s solution was section 197.

### III. LEGISLATIVE INTANGIBLES REFORM/GENESIS

#### A. *The Introduction of Section 197 to the Internal Revenue Code*

Section 13261 of the Omnibus Budget Reconciliation Act of 1993 enacted Internal Revenue Code section 197 and radically changed the tax law on the amortization of acquired intangibles.<sup>173</sup> To recap, under prior law, taxpayers were allowed amortization deductions for the cost or other basis of acquired intangible assets used in a trade or business or held for the production of income if the taxpayer could establish that the intangible had a limited useful life that could be determined with reasonable accuracy.<sup>174</sup> The regulations also stated that no amortization deductions were allowed with respect to goodwill.<sup>175</sup> The IRS generally

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168. *Id.* at 1680 (quoting the opinion of the Court of Appeals, 945 F.2d at 568).

169. *Id.*

170. Brode, *supra* note 148, at 1016.

171. *Id.*

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

173. OBRA '93, Pub. L. No. 103-66, § 13261(a), 107 Stat. 270, 532 (1993).

174. H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 672 (1993), *reprinted in* 1993 U.S.C.A.N. 1361 (West Supp. 7A Sept. 1993) (stating the treatment of acquired intangibles under prior law).

175. *Id.* at 672-73.



disallowed amortization deductions for acquired intangibles on the ground that the claimed amortizable asset either (1) did not have a limited useful life that was reasonably estimable, or (2) that the intangible was actually nonamortizable goodwill or going concern value of the acquired business.<sup>176</sup> While *Newark Morning Ledger* marked an attempt to extricate a number of intangibles from the tangle of goodwill, the Supreme Court's caveat on the taxpayer's burden of proof indicated that continuing disputes and burdensome fact-intensive inquiries remained inevitable. Congress recognized the precedential inadequacy of *Newark Morning Ledger* stating "[t]hese types of disputes can be expected to continue to arise, even after [*Newark Morning Ledger*]."<sup>177</sup>

The stated rationale for the addition of section 197 to the Code was to eliminate controversies concerning the determination of "(1) whether an amortizable intangible asset exists; (2) in the case of an acquisition of a trade or business, the portion of the purchase price that is allocable to an amortizable intangible asset; and (3) the proper method and period for recovering the cost of an acquired amortizable intangible."<sup>178</sup>

Section 197 seeks to eliminate these controversies by (1) specifying a single method and period for recovering the cost of most acquired intangible assets (ratable amortization over fifteen years) and (2) treating acquired goodwill and going concern value as amortizable intangibles. Thus, generally, in a taxable acquisition any purchase price premium that the acquirer pays above the fair market value of the transferee's acquired tangible assets, which could not previously be amortized because the IRS labeled the premium as nonamortizable goodwill or going concern value, may now be treated as a section 197 amortization expense, and may be deducted over a fifteen-year period.<sup>179</sup>

### 1. THE LEGISLATIVE ROLLER COASTER

Although section 197 was not enacted until 1993, it was actually the product of intangibles legislation introduced as House Bill 3035 in 1991 by House Ways and Means Committee Chairman Dan Rostenkowski.<sup>180</sup> Competing legislative initiatives, House Bill 563 and House Bill 1456, were also introduced in 1991, but Rostenkowski's enduring bill was the only legislation that legitimately promised curative and meaningful intangibles reform.<sup>181</sup>

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176. Brode, *supra* note 148, at 1016-17.

177. S. REP. NO. 1134, 103d Cong., 1st Sess. 216 (1993).

178. *Id.*

179. Brode, *supra* note 148, at 1017.

180. H.R. 3035, 102d Cong., 1st Sess. (1991).

181. H.R. 563, 102d Cong., 1st Sess. (1991) (Untitled). This bill was introduced by House Ways and Means Committee member Rep. Brian J. Donnelly, and was the first of the three pieces

of intangibles legislation from the first session of the 102nd Congress. See generally STAFF OF JOINT COMMITTEE ON TAXATION, DESCRIPTION OF PROPOSALS RELATING TO THE FEDERAL INCOME TAX TREATMENT OF CERTAIN INTANGIBLE PROPERTY (H.R. 3035, H.R. 1456, and H.R. 563) (Jt. Comm. Print 1991) (discussing the 1991 legislative initiatives) [hereinafter "*JCT Report 1*"]; Brode, *supra* note 148 (same); Kitchel, *supra* note 8 (same); Bennett Minton & Lee A. Sheppard, *An Intangibles Quandary: To Which Taxpayers Go the Spoils*, 55 TAX NOTES 1568 (1992) (same); Ronald A. Pearlman, *The Amortization of Acquired Intangible Assets: A Subject Whose Time May Have Come*, 52 TAX NOTES 1083 (1991) (same).

House Bill 563 sought to amend Code section 167 non-retroactively, "to clarify that amounts paid to acquire certain intangible items are treated as being paid for goodwill." H.R. 563. The bill labeled "customer base, market share, or any similar intangible" as possessing an indeterminate useful life. *Id.* Consequently, no amortization deductions were allowed under the bill for the cost of acquiring, *inter alia*, customer or subscription lists, bank core deposits, and insurance expirations.

While this approach purported to solve the intangibles controversy by including certain intangibles in the definition of nonamortizable goodwill, it was a poor attempt at a meaningful solution. The bill was essentially a legislative mandate for treatment in accordance with *General Television* or *Newark Morning Ledger* (Third Circuit), but it denied *Houston Chronicle* allowances. The proposed legislation did not provide taxpayers with any direction on how to allocate purchase price premium since it only told them what was *per se* nonamortizable. Consequently, taxpayers would have been encouraged to allocate premium to intangible assets other than customer-based intangibles. Fortunately, House Bill 563 died in committee.

In opposition to House Bill 563 and an IRS Industry Specialization Program paper on intangibles taking the same approach, House Ways and Means Committee members Reps. Guy Vander Jagt, Barbara Kennelly, and Beryl Anthony Jr. introduced the Intangibles Amortization Clarification Act of 1991, House Bill 1456. H.R. 1456, 102d Cong., 1st Sess. (1991). The legislation called for the retroactive amendment of Code section 167 to specify that customer-based, market share, and any similar intangible items were amortizable over their useful lives provided they had "an ascertainable value separate and distinct from other assets (including goodwill or going concern value)," and a reasonably estimable limited useful life. *Id.* House Bill 1456 also granted the Treasury Department authority to promulgate regulations interpreting the bill's mandate and establishing safe harbor recovery periods for eligible intangibles. *Id.*

In his floor statement introducing the bill, Rep. Vander Jagt attacked House Bill 563 and the IRS Coordinated Issue Paper as not only violative of the *Houston Chronicle* standard and fundamental tax principles, but also inconsistent with notions of fairness and sound tax policy. 137 CONG. REC. E969, 969-70 (daily ed. Mar. 18, 1991). The Congressman endorsed the view that acquired wasting intangibles should be afforded treatment similar to that of tangible assets. *Id.* at E969. House Bill 563 and the IRS paper would have, in Rep. Vander Jagt's opinion, further frustrated judicial efforts to close the tangible/intangibles tax-treatment gap and would have resulted in "mismatching" and a muddled reflection of net income. *Id.* House Bill 1456, on the other hand, was advanced as legislative recognition that there was "no *per se* rule of . . . nonamortizability in every case that involves both goodwill and other intangible assets" provided the taxpayer satisfied *Houston Chronicle's* two-prong factual standard. *Id.* at E970 (quoting *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 452 (Cl. Ct. 1976)).

In the end, the bill was merely a reiteration of the unworkable *Houston Chronicle* standard for determining the amortizability of acquired intangibles. See Pearlman, *supra*, at 1084 n.10. House Bill 1456 did not represent any "new legal or economic analysis of the proper tax treatment of goodwill and going concern value." *Id.* at 1084. Fortunately, this piece of intangibles legislation also died in committee.

The Amortization of Intangibles Clarification Act of 1991, S. B. 1245, 102d Cong., 1st Sess. (1991), was subsequently introduced in the Senate in June 1991. The bill was essentially the same as House Bill 1456 and was not enacted. Accordingly, it will not be discussed further.

a. House Bill 3035—"A Bill to Simplify the Tax Treatment of Intangible Assets"

In contrast to House Bill 563, which sought clarification of the tax treatment of intangibles by merely classifying more assets as nonamortizable goodwill, and also in contrast to House Bill 1456, which sought simply to maintain the *status quo ante*, Rostenkowski's solution was House Bill 3035,<sup>182</sup> which proposed a sweeping revision of the laws governing the tax treatment of acquired intangibles. The significance of Rostenkowski's intangibles bill cannot be understated, as it was the only legislative approach to the intangibles controversy that endured and ultimately served as the prototype of section 197.

House Bill 3035 was offered as legislation "intended to provide certainty to taxpayers while eliminating the source of much tax litigation and controversy, thus freeing up for more productive use the resources of taxpayers, the Internal Revenue Service, and the courts."<sup>183</sup> The bill proposed to reach these ends via the enactment of a new Code section, section 197, which would directly address the true problems—disputes over purchase price premium allocations stemming from the nonamortizability of goodwill and the need for an objective and uniform cost recovery system.<sup>184</sup>

House Bill 3035 called for the creation of a new class of intangible asset, the "section 197 intangible," to include goodwill, patents and copyrights, covenants not to compete, customer lists, computer software, and virtually all intangible assets "acquired by the taxpayer after the date of enactment of this section and . . . held in connection with the conduct of a trade or business [or section 212 activity]."<sup>185</sup> The bill sought to curb premium allocation and cost recovery problems by not only broadly defining "section 197 intangibles" to include goodwill, but also by providing for a mandatory uniform cost recovery method and period for all

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182. H.R. 3035, 102d Cong., 1st Sess. (1991).

183. 137 CONG. REC. E2706 (daily ed. July 25, 1991) (statement of Chairman Rostenkowski introducing House Bill 3035).

184. H.R. 3035.

185. H.R. 3035 at prop. I.R.C. § 197(a)-(d). In brief, the term "section 197 intangible" included:

- (1) goodwill; (2) going concern value; (3) certain specified types of intangible property that generally relate to workforce, information base, know-how, customers, suppliers, or other similar items; (4) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof (except for [certain] rights of an indefinite duration . . .); (5) any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (6) any franchise, trademark, or tradename.

JCT REPORT 1, *supra* note 180, at 19.

“section 197 intangibles”—ratable amortization over fourteen years irrespective of true economic life.<sup>186</sup>

The proposed legislation did not, however, purport to change the tax treatment of costs incurred in the creation or maintenance of intangible assets.<sup>187</sup> For example, intangible capital expenditures on advertising and R&D remained currently deductible, and self-created goodwill remained nonamortizable. Further, the bill's rules for uniform fourteen-year ratable amortization did not cover all intangible assets. Several types of intangibles were not subject to proposed section 197 treatment,<sup>188</sup> including intangibles regularly traded on a public market (e.g. bond premiums),<sup>189</sup> certain patents and copyrights,<sup>190</sup> certain contract rights,<sup>191</sup> professional sports franchises,<sup>192</sup> and indefinite governmental rights<sup>193</sup> were among those intangibles. House Bill 3035 also imposed restrictions on loss deductions from the disposition of “section 197 intangibles”<sup>194</sup> and contained anti-churning<sup>195</sup> and anti-abuse rules.<sup>196</sup>

Although House Bill 3035 did employ a “rough justice” approach,<sup>197</sup> it nonetheless received widespread approval from tax professionals. Commissioner of Internal Revenue Fred Goldberg, Jr. applauded the bill's simplicity, stating “I cannot overemphasize the importance of simplicity and uniformity in this area—it is easier to administer, to understand, to comply with, and it curbs further ‘discoveries’ of

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186. H.R. 3035 at prop. I.R.C. § 197(a)-(d).

187. 137 CONG. REC. E2706 (daily ed. July 25, 1991) (introductory statement of Chairman Rostenkowski).

188. See generally Kevin M. Helmich, *The Amortization of Intangible Assets: An Analysis of H.R. 3035 Proposed by House Ways and Means Committee Chairman Dan Rostenkowski*, 55 Tax Notes 987 (1992).

189. H.R. 3035 at prop. I.R.C. § 197(d)(4)(A).

190. *Id.* at prop. I.R.C. § 197(d)(4)(C) (patents and copyrights not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business (or a substantial portion thereof)).

191. *Id.* at prop. I.R.C. § 197(d)(4)(B) (nonrenewable contracts rights of a fixed duration not acquired in a transaction involving the acquisition of assets constituting a trade or business or substantial portion thereof).

192. *Id.* at prop. I.R.C. § 197(d)(4)(D).

193. *Id.* at prop. I.R.C. § 197(d)(4)(E).

194. H.R. 3035 at prop. I.R.C. § 197(e)(1). If the taxpayer disposed of an amortizable intangible “acquired in a transaction or series of related transactions (or any such intangible [became] worthless)” and retained other “section 197 intangibles” acquired in the transaction, then no loss could be recognized, but the adjusted bases of the retained amortizable intangibles could be increased by the amount of the loss not recognized. *Id.*

195. *Id.* at prop. I.R.C. § 197(e)(7).

196. *Id.* at prop. I.R.C. § 197(e)(7)(D).

197. For example, by legislatively adopting a single amortization period for all industries, those industries that succeeded in amortizing intangibles over lives shorter than the prescribed 14-year period would be harmed by the longer cost recovery period mandated by the bill. See discussion *infra* part III.A.1.(a)(i).

intangibles.”<sup>198</sup> The New York State Bar Association Tax Section endorsed the bill as consistent with the economic reality that “[g]oodwill is plainly a wasting asset, although without a determinable useful life” and, hence, facilitates “matching.”<sup>199</sup> The General Accounting Office supported the bill’s inclusion of goodwill since it would not only recognize that goodwill often wastes, but also it would likely “enhance the international competitiveness of U.S. businesses” by conforming to the international treatment of goodwill and more closely approximating the financial accounting treatment of goodwill as dictated by generally accepted accounting principles (“GAAP”).<sup>200</sup>

Opposition to the bill came largely from industries on the losing side of the timing-of-cost-recovery-benefit distribution.<sup>201</sup> For example, the computer software industry enjoyed an established amortization period of five years or less, but under the bill the cost recovery period for software would have been increased to fourteen years.<sup>202</sup> Mortgage bankers, film companies, and cable companies were also among the taxpayers who resisted House Bill 3035’s enactment.<sup>203</sup> Largely in response to the outcries of opponents, House Bill 3035 was modified and reintroduced in subsequent legislation. It nevertheless remained the paradigm for what would become section 197.

#### i. From Rostenkowski’s Intangibles Bill to Section 197

House Bill 3035 was subsequently incorporated into House Bill 4210. This bill was passed by Congress in March 1992,<sup>204</sup> but vetoed by President Bush.<sup>205</sup> Section 4501 of House Bill 4210 was generally derived from its predecessor, but the bill (1) carved out a limited exception for computer software, allowing recovery over thirty-six months instead of fourteen years,<sup>206</sup> and (2) provided for elective retroactivity to July 25, 1991.<sup>207</sup>

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198. *Statement of Fred. T. Goldberg, Jr., Commissioner of Internal Revenue, Before Committee on Ways and Means, United States House of Representatives*, 91 TAX NOTES TODAY 223-32, Oct. 30, 1991, available in LEXIS, Taxria Library, TNT File. For a taste of the “discoveries” of intangibles to which Commissioner Goldberg was referring, see Appendix.

199. NYSBR, *supra* note 111, at 948.

200. GAO REPORT, *supra* note 11, at 33-35.

201. See Kenesey, *supra* note 50, at 871.

202. *Id.* at 871-72.

203. *Id.* at 871 n.154 (listing some of the “losers” under the bill). See discussion *infra* part III.A.1.(a)(i).

204. H.R. 4210, 102d Cong., 1st Sess. § 4501 (1992) (the Tax Fairness and Economic Growth Act of 1992).

205. Vetoed on March 20, 1992.

206. *Id.* at prop. I.R.C. §§ 197(e)(3), 167(f)(1).

207. *Id.* § 4501(g)(1)-(3). This transition rule allowed taxpayers to elect to amortize acquired intangible property ratably over 17 years instead of 14 years. *Id.*

While the industry groups that would have been most affected by this legislation lauded the bill for its certainty and simplicity, they nonetheless generally disapproved of any extended amortization period. Refreshingly, the insurance industry supported section 4501 of House Bill 4210. Although it fell on the losing side of the benefit distribution in terms of timing cost recovery, industry advocates believed the bill "would bring simplification, eliminate the cost of valuation experts, eliminate the cost of tax lawyers, and make it possible for people to spend more time running their businesses and less time fighting with the Internal Revenue Service."<sup>208</sup>

Unlike the insurance industry, the mortgage banking industry staunchly opposed the intangibles provision of House Bill 4210 since it called for increasing the amortizable life of mortgage servicing rights from an industry average of approximately a seven- to ten-year period to a fourteen-year period.<sup>209</sup> The industry maintained that the increased cost-recovery period would result in decreased values of mortgage servicing rights and, consequently, increased borrowing costs for residential mortgagors.<sup>210</sup> For example, an increased amortization period translated to a decrease of \$500 in the value of mortgage servicing rights on a \$100,000 mortgage. This difference would be passed on to the mortgagor, who would pay an extra \$500 in closing costs per every \$100,000 in mortgage financing.<sup>211</sup>

Similarly, the high technology industry appreciated the bill's simplicity and carve-out treatment for off-the-shelf software, but urged Congress to grant it additional exclusions from the fourteen-year cost recovery period to maintain its international competitive posture.<sup>212</sup> The tax law for most foreign competitors allowed either a current deduction or an amortization deduction over five years or less for technology acquisition expenses.<sup>213</sup> An industry spokesman posited that House Bill

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208. *Hearings, supra* note 7, at 18 (testimony of Kenneth J. Kies, Counsel, Amortization of Intangibles Task Force). The cost of insurance expiration lists were generally recovered over a five- to seven-year period. *Id.*

209. *Id.*, *supra* at 29-30 (testimony of Stephen B. Ashley, Chairman and CEO, Sibley Mortgage Co. and Vice President, Mortgage Bankers Association of America).

210. *Id.* at 32-33 (testimony of Curtis B. Uhre, President, Home Finance Coalition, Inc.).

211. *Id.* Thus, opponents argue, assuming the mortgage-debt servicer and the mortgagor are subject to the same tax rates, the inclusion of mortgage servicing rights in section 197 would not generate additional revenues since the costs passed on to the mortgagor would be deductible as a mortgage interest expense.

212. *Id.* at 33-34 (testimony of Robert S. Cooper, President and CEO, Atlantic Aerospace Corp., on behalf of the Information Technology Association of America).

213. *Id.* at 34. At the time of the intangibles hearings before the Senate Committee on Finance, Canada, France, and Germany allowed software-acquisition expenses to be written off over three years. Japan allowed a five-year writeoff, and the United Kingdom and a number of other U.S. trading partners permitted software acquisition costs to be amortized over five years or less. *Id.* at

4210 would give an advantage to foreign competitors in the acquisition of U.S. technology and innovation because the proposed law would increase the after-tax costs of technology acquisitions by United States taxpayers by 12 to 20 percent.<sup>214</sup> Moreover, the high technology industry maintained that the fourteen-year amortization period would result in mismatching income and expenses because the useful lives of innovations in many high-technology fields are much shorter than fourteen years.<sup>215</sup> Likewise, the software industry urged Congress to broaden its exemption for software to encompass not only off-the-shelf software, where the purchaser buys the mere right to use a copy of the software, but also software purchased as part of a business acquisition, where the acquirer obtains ownership rights in the software.<sup>216</sup>

In contrast, the airline industry supported the legislation outright.<sup>217</sup> It favored the increased certainty in recovering acquisition costs of airline routes and slots and airport gates.<sup>218</sup> The Air Transport Association of America also approved of the bill because it facilitated overall matching, "which is the tax policy basis for all depreciation and amortization expenses."<sup>219</sup> The Association argued,

[t]he sale of slots and routes results in income to the seller which is taxable gain to the extent the sales price exceeds the basis of the asset. If the selling airline was originally granted this slot or route authority by the government, the basis of the asset may be virtually zero, and thus the entire sale price would result in a taxable gain to the seller—but without the ability to amortize the acquisition costs, there would be no matching expense item for the buyer.<sup>220</sup>

Understandably, the banking industry strongly supported the bill for its simplification and regarded the inclusion of a provision allowing the amortization of goodwill as essential to the simplification effort.<sup>221</sup> The industry noted that it was likely to experience further consolidation, which would result in increased acquisitions of intangible financial assets, and the bill's intangibles provisions would increase transactional certainty and efficiency.<sup>222</sup>

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36-37 (testimony of William P. Benac, Treasurer, Electronic Data Systems, on behalf of The Information Technology Association of America).

214. *Id.* at 34 (testimony of Robert S. Cooper).

215. *Id.* See, e.g., *Hearings, supra* note 7, at 36 (William Benac of EDS testified that Lotus Development Corp's software program, 1-2-3, had major updates and been re-released five times since its introduction in 1983 until August of 1991).

216. *Id.* at 36.

217. *Id.* at 140 (statement of the Air Transport Association. of America).

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.* at 141 (statement of the American Bankers Association).

222. *Id.*

The telephone industry also had a sizable interest in the intangibles provision. BellSouth urged Congress to adopt intangibles legislation that would include government-granted licenses and franchises within the meaning of a "section 197 intangible."<sup>223</sup> In addition, BellSouth joined with the high-technology industry in arguing for more carve-out treatment for purchased software.<sup>224</sup>

Perhaps the most heartfelt disapproval came from the Chairman of The Committee on Taxation of Intangible Assets, an *ad hoc* group of independent home heating retailers and other small businesses.<sup>225</sup> Home heating retailers maintained that the value of their business would substantially decline if they were forced to amortize customer lists and non-compete agreements over an extended period.<sup>226</sup> In the home heating oil business, non-compete agreements generally run for, and are amortized over, five years.<sup>227</sup> The lifetime of a purchased customer list averages approximately seven years.<sup>228</sup> The committee's spokesman explained:

Because of the very high percentage of intangibles in the total asset value [of such small businesses] and the very low percentage of goodwill, [House Bill] 4210 causes a significant decline in the value of the heating dealer's life's work. I am sure it was not intended, but when you wake up 1 day and find out that your life's earnings are down by 10, 12, or 15 percent overnight, not by a change in policy, but because of a simplification measure, that is not fair.<sup>229</sup>

Others voiced concern over the intangibles legislation because it would, in effect, subsidize M&A activity.<sup>230</sup> Since goodwill and going concern value were not amortizable during the M&A mania of the 1980s, some felt that allowing the amortization of these intangibles, which are common in larger businesses, would amount to Congressional encouragement of mergers and acquisitions.<sup>231</sup>

Despite the overwhelming pleas for some form of intangibles reform, President Bush vetoed the Tax Fairness and Economic Growth Act of 1992 (House Bill 4210). Nonetheless, it was clear that the push for intangibles legislation had not lost its momentum. In June 1992, the

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223. *Id.* at 145 (statement of BellSouth). Likewise, the cable industry now supported the legislation since it included amortization allowances for cable television franchises, a type of government license. *Id.* at 182 (statement of the National Cable Television Association).

224. *Id.* at 145.

225. *Id.* at 37-38 (testimony of John G. Buckley, President, The Buckley Co., on behalf of the Committee on Taxation of Intangible Assets).

226. *Id.* at 37.

227. *Id.*

228. *Id.* at 38.

229. *Id.*

230. *Id.* at 13 (testimony of Willie L. Baker, Jr.).

231. *Id.* See *supra* note 11 and accompanying text; see also discussion *infra* part III.2.(b).



Senate Finance Committee approved House Bill 3040.<sup>232</sup> The bill's provisions for amortization of intangibles were based on those contained in House Bill 4210,<sup>233</sup> but the Senate extended the fourteen-year amortization period to sixteen years<sup>234</sup> and adopted a transition rule, which would allow a taxpayer to elect to apply the new tax law retroactively to seventy-five percent of all intangibles acquired in open years, in addition to all intangibles acquired after July 25, 1991.<sup>235</sup> This legislation was carried over into the next congressional session and was incorporated into the Revenue Act of 1992—House Bill 11.<sup>236</sup> The October 1992 Conference Report to House Bill 11 adopted the House's fourteen-year amortization provision and dropped the open years transition rule.<sup>237</sup> The bill was summarily vetoed by the President in November 1992.

Rep. Rostenkowski's intangibles legislation was reintroduced in the first session of the 103d Congress as part of the Tax Simplification Act of 1993.<sup>238</sup> Although the original legislation was designed as a revenue-neutral simplification provision, it became scored as a revenue raiser after the Supreme Court's decision in *Newark Morning Ledger*.<sup>239</sup> Consequently, intangibles provisions were included in both the House and Senate versions of OBRA '93.<sup>240</sup> The House bill proposed a fourteen-year amortization period and was expected to raise about \$2.1 billion over five years.<sup>241</sup> The Senate amendment allowed taxpayers to take fourteen-year ratable amortization deductions for seventy-five percent of an acquired intangible's adjusted basis and was expected to raise over \$5 billion over five years.<sup>242</sup>

The conference agreement to section 13261 of OBRA '93 followed the House bill, but extended the amortization period to fifteen years and excluded certain purchased mortgage servicing rights from the definition

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232. H.R. 3040, 102d Cong., 1st Sess. (1992).

233. *Id.* § 302(a).

234. *Id.* at prop. I.R.C. § 197(a).

235. *Id.* § 302(g)(1)-(3). The remaining 25 percent was to be treated as nonamortizable goodwill. *Id.* § 302(g)(3)(A)(ii).

236. H.R. 11, 102d Cong., 2d Sess. § 4551 (1992). The bill allowed an election to apply its provisions retroactively to 50% of certain intangibles acquired in open years for which amortization was claimed. *Id.* at prop. I.R.C. § 197(g)(3).

237. Brode, *supra* note 148, at 1012 n.2.

238. See H.R. 13, 103d Cong., 1st Sess. § 501 (1993).

239. Marc D. Levy, et al., *Supreme Court's Decision on Amortizing Intangibles Removes One Barrier*, 79 J. TAX'N 4, 8 (1993).

240. See H.R. 2264, 103d Cong., 1st Sess. § 14261 (1993) (House version of OBRA '93 (introduced in May 1993)); S. 1134, 103d Cong., 1st Sess. § 8261 (1993) (Senate version of OBRA '93 (introduced in June 1993)).

241. James C. Diana, *Amortization of Customer-Based intangibles*—*Newark Morning Ledger v. U.S.*, 34 TAX MGMT. MEMORANDUM 223, 228 (1993).

242. *Id.*

of a "section 197 intangible."<sup>243</sup> Thereafter, OBRA '93 became law and section 197 was born.<sup>244</sup>

## 2. INTERNAL REVENUE CODE SECTION 197—THE LEGISLATIVE SOLUTION TO THE INTANGIBLES QUANDARY

### a. An Overview of New Code Section 197

Section 197 should substantially eliminate disputes over purchase price allocations and the amortization of acquired intangible assets by permitting the amortization of goodwill and by providing a uniform recovery period for most acquired intangible assets. Section 197 does have its problems, though. For example, basis allocation is still necessary due to a loss disallowance provision. This provision will inevitably result in disputes with the IRS over the appropriate allocation of purchase price among "section 197 intangibles."<sup>245</sup> Further, section 197 does not cure the backlog of disputes that predate the law.<sup>246</sup>

Under section 197, a taxpayer is allowed to take amortization deductions for any amortizable "section 197 intangible."<sup>247</sup> A intangible is amortizable if it is not expressly excluded from the definition of a "section 197 intangible," is acquired<sup>248</sup> by the taxpayer after August 10, 1993,<sup>249</sup> and is held in connection with the conduct of a trade or business

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243. H. R. CONF. REP. NO. 213, *supra* note 173, at 694.

244. OBRA '93, Pub. L. No. 103-66, § 13261(a), 107 Stat. 270, 532-38 (1993).

245. Under I.R.C. § 197(f)(1), if there is a disposition of any "amortizable section 197 intangible" acquired in a transaction or any such intangible becomes worthless, and if other intangibles acquired in the transaction are retained, then (1) no loss may be recognized on the disposition or worthlessness of the intangible and (2) the adjusted bases of such retained intangibles may be adjusted to take account of the loss not recognized. I.R.C. § 197(f)(1)(A) (Supp. V 1993). Section 197(f)(1) does not include a provision for the nonrecognition of gain on dispositions; thus, a taxpayer must recognize gain, but may not recognize loss. Special loss disallowance rules apply to covenants not to compete and similar arrangements. *See* I.R.C. § 197(f)(1)(B); *see also* discussion *infra* part III.A.2.(a)(i)(d).

246. *See* H.R. CONF. REP. NO. 213, *supra* note 173, at 690 (Congress urged the IRS "in the strongest possible terms to expedite the settlement of cases . . . tak[ing] into account the principles of [section 197] so as to produce consistent results for similarly situated taxpayers.").

247. I.R.C. § 197(a). The Treasury Department will amend the regulations under I.R.C. § 1060 to categorize all amortizable "section 197 intangibles" as Class IV assets. H.R. CONF. REP. NO. 213, *supra* note 173, at 689.

248. Either by direct acquisition or by a section 338 election. H.R. CONF. REP. NO. 213, *supra* note 173, at 673. I.R.C. § 338 allows certain stock purchases to be treated as asset purchases. If a purchasing corporation elects to make a "qualified stock purchase" of a target corporation's stock, the target corporation is treated as having sold its assets for fair market value. I.R.C. § 338(a) (1988 & Supp. V 1993).

249. Section 197 is effective for section 197 intangibles acquired after August 10, 1993. There are two exceptions: (1) the taxpayer may elect out of section 197 and apply prior law to property acquired under a written contract which was in effect on August 10, 1993 and at all times thereunder until the acquisition (the "elective binding contract exception"); and (2) the taxpayer may elect to apply the new rules retroactively to all property acquired after July 25, 1991. Such

or section 212 activity.<sup>250</sup> Self-created intangibles that are not specifically included under the definition of "section 197 intangibles" or that are created in connection with a transaction (or series of related transactions) that involves the acquisition of a trade or business or a substantial portion thereof are not "amortizable section 197 intangibles."<sup>251</sup> In addition, section 197 contains anti-churning<sup>252</sup> rules which may remove some transactions from section 197's amortization provisions.<sup>253</sup>

The amortization deduction allowed for an "amortizable section 197 intangible" is determined by ratably amortizing its adjusted basis "over a 15-year period, beginning with the month in which such intangible was acquired."<sup>254</sup> The section 1011 basis rules are used to determine the "section 197 intangible's" adjusted basis.<sup>255</sup> If a "section 197 intan-

an election can only be revoked with IRS consent and also binds other entities under common control with the taxpayer at any time between August 2, 1993 and the election date. OBRA '93, Pub. L. No. 103-66, § 13261(g), 107 Stat. 270, 540 (1993). Forthcoming Treasury regulations should provide guidance to the taxpayer on these elections. Moreover, taxpayers cannot avoid section 197's effective date by engaging in certain nonrecognition transactions (i.e., transactions involving section 332, 351, 361, 721, 731, 1031, or 1033 of the Code). H.R. CONF. REP. NO. 213, *supra* note 173, at 693.

250. I.R.C. § 197(c)(1).

251. *Id.* § 197(c)(2).

252. The anti-churning rules prevent taxpayers from converting previously nonamortizable goodwill, going concern values (or any other intangible that would not have been amortizable but for section 197) into "section 197 intangibles" by transferring those assets to related parties. Such assets will not be "amortizable section 197 intangibles" if they are acquired after August 10, 1993 and either

(1) the intangible was held or used at any time on or after July 25, 1991, and [before August 11, 1993] by the taxpayer or a related person, (2) the intangible was acquired from a person who held [it] at any time on or after July 25, 1991, and [before August 10, 1993], and, as part of the transaction, the user of such intangible does not change, or (3) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 24, 1991 and [before August 11, 1993].

*Id.* § 197(f)(9)(A). For purposes of this provision, a "related person" is a person defined in section 267(b), section 707(b)(1) (applying a 20% test instead of a 50% test), or is a trade or business under common control within the meaning of section 41(f)(1). *Id.* § 197(f)(9)(C). If the parties' relationship is between 20% and 50%, then the anti-churning rules do not apply provided the seller agrees to recognize gain on the sale and to pay the highest applicable tax rate on that gain. *Id.* § 197(f)(9)(B). The anti-churning rules also contain an anti-abuse provision. *Id.* § 197(f)(9)(F).

253. *Id.* § 197(f)(9).

254. *Id.* § 197(a). The number of months are used for determining the amortization deduction in the case of a short taxable year. H.R. CONF. REP. NO. 213, *supra* note 173, at 673 n.1.

255. I.R.C. §§ 167(c)(1), 197(a), (f)(7). Further, the adjusted basis of an acquired "section 197 intangible" is generally determined under the rules that apply to acquired tangible property. H.R. CONF. REP. NO. 213, *supra* note 173, at 685. Thus, in the case of contingent payments, the adjusted basis of an acquired intangible increases as payments are actually made or incurred, and such amounts are amortized ratably over the remaining months in the 15-year amortization period that applies to the intangible, beginning with the month that the payments are made or incurred. *Id.*

gible" is transferred in certain nonrecognition transactions,<sup>256</sup> then the transferee must treat the carryover basis of the intangible the same as that basis was treated by the transferor, and any new basis is amortized as if a new "section 197 intangible" was acquired.<sup>257</sup>

The Code treats a "section 197 intangible" as property which is subject to the allowance for depreciation in accordance with section 167.<sup>258</sup> Therefore, it is excluded from the definition of a capital asset.<sup>259</sup> Instead, "amortizable section 197 intangibles" held for more than one year are considered section 1231 quasi-capital assets.<sup>260</sup> Accordingly, if the aggregate gains on "section 197 intangibles" and other section 1231 assets exceed the losses on such assets, the net gain is treated as long-term capital gain.<sup>261</sup> On the other hand, if a net loss results from the combination of losses on all 1231 assets, then such loss is ordinary in character.<sup>262</sup>

At first glance, it appears that "section 197 intangibles" operate in the best of all possible worlds. However, section 197's loss disallowance rules may destroy this appearance.<sup>263</sup> Furthermore, "section 197 intangibles" are considered section 1245 property<sup>264</sup> and are therefore subject to amortization recapture.<sup>265</sup>

#### i. Definition of Section 197 Intangible<sup>266</sup>

The Code defines a "section 197 intangible" as property that is included in any one or more of the following categories: (1) goodwill and going concern value; (2) specified types of intangible property that relate generally to workforce, information base, knowhow, and other intellectual property, customer-based, supplier-based, and similar items; (3) licenses, permits, or other rights granted by a governmental unit or an agency or instrumentality thereof; (4) covenants not to compete or

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256. Namely, transactions under I.R.C. §§ 332, 351, 361, 721, 731, 1031, or 1033, or "any transaction between members of the same affiliated group during any taxable year for which a consolidated return is [filed]." I.R.C. § 197(f)(2)(B).

257. *Id.* § 197(f)(2)(A). Consistent with these basis rules for nonrecognition transactions, if, in a partner-partnership transaction, a partner acquires an interest in an intangible held through a partnership, then section 197 applies only if, and to the extent that, the partner gets a basis increase for such intangible. H.R. CONF. REP. NO. 213, *supra* note 173, at 686.

258. I.R.C. § 197(f)(7).

259. *Id.* § 1221(2) (1988).

260. H.R. CONF. REP. NO. 213, *supra* note 173, at 688.

261. I.R.C. § 1231(a)(1) (1988).

262. *Id.* § 1231(a)(2) (1988).

263. *See* I.R.C. § 197(f)(1) (disallowance of recognition of losses on certain dispositions).

264. H.R. CONF. REP. NO. 213, *supra* note 173, at 688.

265. I.R.C. § 1245(a) (1988 & Supp. V 1993).

266. This section will not address Code § 197(f)(5)'s rules on assumption reinsurance transactions.

similar arrangements entered into in connection with direct or indirect acquisitions of an interest in a trade or business (or a substantial portion thereof); and (5) franchises, trademarks, or tradenames.<sup>267</sup>

a. Goodwill and Going Concern Value

For purposes of section 197, the Code defines goodwill as "the value of a trade or business that is attributable to the expectancy of continued patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor."<sup>268</sup> Thus, Congress accepted the definition of goodwill that evolved in the courts.<sup>269</sup>

Going concern value is defined as "the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern."<sup>270</sup> It includes the value derived from the ability of a business to continue to function without interruption despite a change in ownership. Going concern value also includes the value attributable to the use or availability of an acquired trade or business (such as profits that otherwise would not be realized during any period in which the acquired business was not available or operational).<sup>271</sup>

Given the expansive definitions of goodwill and going concern value and the uniform amortizability of virtually all acquired intangible assets, disputes over the allocation of purchase price to goodwill and similar intangibles should become a rarity, and imaginative taxpayer definitions of intangibles should greatly decrease.

b. Workforce in Place, Information Base, Knowhow and Other Intellectual Property, Customer-Based Intangibles, Supplier-Based Intangibles, and Other Similar Intangibles

"Workforce in place" (sometimes called "agency force" or "assembled workforce") is considered a "section 197 intangible."<sup>272</sup> "Workforce in place includes its composition [the experience, education, and training] and terms and conditions (contractual or otherwise) of its employment,"<sup>273</sup> and any other value attributable to employees.<sup>274</sup> Thus, in a business acquisition, any purchase price attributable to the

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267. I.R.C. § 197(d).

268. H.R. CONF. REP. NO. 213, *supra* note 173, at 674.

269. See, e.g., *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 450-51 (Ct. Cl. 1976) (surveying prior judicial definitions of goodwill).

270. H.R. CONF. REP. NO. 213, *supra* note 173, at 674.

271. *Id.*

272. I.R.C. § 197(d)(1)(C)(i).

273. *Id.*

274. H.R. CONF. REP. NO. 213, *supra* note 173, at 675.

existence of a highly skilled workforce is amortizable over fifteen years, as is the cost allocable to any "key employee" contract.<sup>275</sup>

Similarly, a "purchased information base," such as business books and records, operating systems, and lists and other customer information is also a "section 197 intangible."<sup>276</sup> Thus, the costs of acquiring customer lists, insurance expirations,<sup>277</sup> patient and client files, newspaper subscription lists, data files, technical manuals, training manuals, accounting and inventory control systems, and similar intangibles are amortizable over a fifteen-year period.<sup>278</sup> Consequently, section 197 displaced the *Newark Morning Ledger* analysis for the amortization of subscription lists and similar purchased intangible assets.

The term "section 197 intangible" also encompasses intellectual property, including patents, copyrights, formulas, designs, patterns, knowhow, formats, package designs, computer software, and interests in films, sound recordings, video tapes, books, and similar assets, unless specifically addressed elsewhere in section 197.<sup>279</sup> Patents, copyrights, and interests in films, recordings, and books may be excluded from the definition of an "amortizable section 197 intangible" if such interests are not acquired in the purchase of a trade or business.<sup>280</sup> Computer software is excluded if it is off-the-shelf or if it is not acquired as part of a business acquisition.<sup>281</sup>

Section 197 provides a separate category for "customer-based intangibles." This category includes composition of market, market share, bank core deposits,<sup>282</sup> and "any other value resulting from future provision of goods and services pursuant to relationships (contractual or otherwise) in the ordinary course of business."<sup>283</sup> Customer-based intangibles have value apart from customer lists and other information-based intangibles, even though the two categories often are inextricable. Therefore, it appears that one form of intangible may serve as evidence of the value of the other.<sup>284</sup> The portion of the purchase price allocable to acquired customer base, circulation base, undeveloped market or mar-

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275. *Id.*

276. I.R.C. § 197(d)(1)(C)(ii).

277. Accordingly, section 197 has rendered the issues presented in *Richard S. Miller & Sons* and *Decker* moot.

278. H.R. CONF. REP. NO. 213, *supra* note 173, at 675.

279. I.R.C. § 197(d)(1)(C)(iii); H.R. CONF. REP. NO. 213, *supra* note 173, at 675.

280. I.R.C. § 197(e)(4).

281. *Id.* § 197(e)(3).

282. *Id.* § 197(d)(2)(B). Consequently, section 197 eliminated the intangibles issues presented in *AmSouth Bancorporation*, *Colorado National*, and *Citizens & Southern*. See discussion *infra* part II.C.

283. *Id.* § 197(d)(2)(A)(iii).

284. For example, customer lists—information-based intangibles—may be used to determine the value attributable to customer base or market share—customer-based intangibles.

ket growth, investment management contracts, and other customer-based intangibles is amortizable over fifteen years.<sup>285</sup> Importantly, any portion of the purchase price attributable to accounts receivable or similar income items arising from the provision of goods and services to customers prior to the acquisition of the trade or business is not a "section 197 intangible."<sup>286</sup>

Acquired "supplier-based intangibles" are also amortizable under section 197.<sup>287</sup> This group of intangibles "is defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer."<sup>288</sup> Thus, the portion of the purchase price of a business allocable to the existence of a favorable distribution relationship (e.g., retail shelf or display space), a favorable credit rating, or a favorable supply contract is amortizable over fifteen years.<sup>289</sup>

#### c. Licenses, Permits, and Other Rights Granted by Governmental Units

The Code defines licenses, permits, and other rights granted by a governmental unit or agency thereof as a "section 197 intangible."<sup>290</sup> Such intangibles are amortizable over fifteen years even if the right is granted or reasonably expected to be renewed for an indefinite period.<sup>291</sup> For example, the capitalized cost of acquiring a taxi-cab medallion, a liquor license, an airport slot, a regulated airline route, or a television or radio broadcasting license is amortizable over section 197's prescribed fifteen-year period.<sup>292</sup> If, however, the acquired right constitutes an interest in land or an interest under a lease of tangible property, the Code excludes it from the definition of "section 197 intangible."<sup>293</sup>

#### d. Covenants Not to Compete and Similar Arrangements

The term "section 197 intangible" includes covenants not to com-

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285. H.R. CONF. REP. NO. 213, *supra* note 173, at 675-76.

286. *Id.* at 676. Instead, the part of the purchase price attributable to acquired accounts receivable is allocated among such receivables. The attributable portion is taken into account as payment is received or at the time the receivable becomes worthless. *Id.* at 676 n.4.

287. I.R.C. § 197(d)(1)(C)(v).

288. H.R. CONF. REP. NO. 213, *supra* note 173, at 676.

289. *Id.*

290. I.R.C. § 197(d)(1)(D). A renewal of these rights is considered an acquisition for purposes of section 197. *Id.* § 197(f)(4)(B).

291. H.R. CONF. REP. NO. 213, *supra* note 173, at 676.

292. *Id.*

293. *See* I.R.C. § 197(e)(2), (e)(5)(A).

pete<sup>294</sup> entered into in connection with a direct or indirect acquisition of an interest in a trade or business, or a substantial portion thereof.<sup>295</sup> This definition includes arrangements which have substantially the same effect as a covenant not to compete, such as consulting agreements with the former owner. The acquired assets of a business, stock in a corporation, and partnership interests are considered interests in a trade or business for purposes of this provision.<sup>296</sup>

If an acquisition qualifies under section 197, any amount paid or incurred under a covenant not to compete or similar arrangement is chargeable to the capital account and amortizable over fifteen years.<sup>297</sup> Furthermore, if a payment is made under a covenant after the taxable year in which the covenant was entered into, the payment must be amortized ratably over the applicable remaining period of the fifteen-year period that applies to the covenant, beginning with the month the payment was made or incurred.<sup>298</sup>

Arrangements similar to or associated with covenants not to compete, such as consulting agreements that require the former owner to perform services or provide property for the acquired business, fall within section 197 to the extent that the amount paid to the former owner exceeds the reasonable compensation for services rendered or property supplied.<sup>299</sup> Consistent with present law, if an amount paid or incurred under such an arrangement represents additional consideration for the acquisition of stock in a corporation, the amount may not be included under section 197, but must be included as part of the acquirer's basis in the stock.<sup>300</sup> Consequently, disputes regarding proper allocation will likely continue with respect to covenants not to compete.

Section 197's loss disallowance provision contains a special rule for covenants not to compete and similar arrangements.<sup>301</sup> A taxpayer may not treat such intangibles as disposed of or worthless until the disposition of the entire interest in the business (or substantial portion thereof), acquired in connection with the covenants.<sup>302</sup> Thus, in many cases a taxpayer must wait to take a loss deduction.

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294. H.R. CONF. REP. NO. 213, *supra* note 173, at 677.

295. I.R.C. § 197(d)(1)(E).

296. H.R. CONF. REP. NO. 213, *supra* note 173, at 677.

297. I.R.C. § 197(f)(3).

298. H.R. CONF. REP. NO. 213, *supra* note 173, at 677.

299. *Id.*

300. *Id.* Apparently, this provision does not apply if a section 338 election is made.

301. I.R.C. § 197(f)(1)(B).

302. *Id.*



e. Franchises, Trademarks, and Tradenames

The term "section 197 intangible" also includes any franchise,<sup>303</sup> trademark, or tradename.<sup>304</sup> Any renewal of a franchise, trademark or tradename is treated as an acquisition, but only to the extent of the costs incurred in connection with such renewal.<sup>305</sup> In addition, the rules set forth in section 1253(d)(1), regarding contingent payments, are applicable to these transactions.<sup>306</sup> Thus, a deduction is allowed for payments that are contingent on the productivity, use, or disposition of a franchise, trademark, or tradename only if (1) the contingent amounts are paid as part of a series of payments that are payable at least annually throughout the term of the transfer agreement, and (2) the payments are substantially equal in amount or are payable under a fixed formula.<sup>307</sup> Any other amount that is paid or incurred in connection with the transfer is capitalized and amortized in accordance with section 197.<sup>308</sup>

ii. Intangibles Excluded From Section 197

Certain assets are specifically excluded from the definition of "section 197 intangible." These include (1) various financial interests; (2) any interest in land; (3) certain computer software; (4) certain interests in films, sound recordings, video tapes, books, or other similar property; (5) certain rights to receive tangible property or services; (6) certain interests in patents or copyrights; (7) interests under leases of tangible property; (8) certain interests under indebtedness; (9) professional sports franchises, (10) certain transaction costs; (11) certain fixed-term or fixed-duration rights received under a contract or granted by a governmental unit or agency thereof; and (12) mortgage servicing rights.<sup>309</sup> Moreover, certain "self-created" intangibles are also excluded.<sup>310</sup>

A number of exceptions to the "section 197 intangible" definition apply only if the intangible property is not acquired in a transaction involving the purchase of a trade or business or a substantial portion thereof. Whether the acquired assets constitute a substantial portion of a trade or business is a facts and circumstances determination.<sup>311</sup> Consid-

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303. The term "franchise" is defined in I.R.C. § 1253(b)(1), and "includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." I.R.C. § 1253(b)(1) (1988 & Supp. V 1993).

304. I.R.C. § 197(d)(1)(F).

305. *Id.* § 197(f)(4)(B).

306. *Id.* § 197(f)(4)(C).

307. I.R.C. § 1253(d)(1).

308. H.R. CONF. REP. NO. 213, *supra* note 173, at 678.

309. I.R.C. § 197(e).

310. *Id.* § 197(c)(2).

311. H.R. CONF. REP. NO. 213, *supra* note 173, at 678.

eration should be given to the nature and amount of the assets retained by the transferor.<sup>312</sup> This determination should not be based entirely upon the value of the assets acquired relative to the value of the assets retained by the transferor.<sup>313</sup>

"[A] group of assets . . . constitute[s] a trade or business if the use of such assets would constitute a trade or business for purposes of section 1060 of the Code (i.e., if the assets are of such a character that goodwill and going concern value could under any circumstances attach to the assets)".<sup>314</sup> In determining whether the assets transferred constitute a trade or business, only those assets acquired by a taxpayer (and related parties) from the same transferor (and related parties) are considered.<sup>315</sup> Additionally, any covenants not to compete or similar arrangements that are entered into as part of the transfer of assets are also considered.<sup>316</sup>

#### a. Financial Interests

Interests in corporations, partnerships, trusts, or estates are not subject to section 197.<sup>317</sup> Likewise, section 197 excludes any interest under an existing futures contract, foreign currency contract, notional principal contract, or similar financial contract—such as an interest rate swap.<sup>318</sup> However, any interest under a mortgage servicing contract, credit card contract, or similar debt-servicing contract issued by another person is generally not excluded from the purview of section 197.<sup>319</sup> Taxpayers may not use term interests in property to convert a "section 197 intangible" into property eligible for faster cost recovery.<sup>320</sup>

#### b. Interests in Land

Interests in land are nonamortizable under section 197.<sup>321</sup> For purposes of section 197, "an interest in land includes a fee interest, life estate, remainder, easement, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, any other similar rights with respect to land."<sup>322</sup> Airport landing or takeoff rights, regulated airline

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312. *Id.*

313. *Id.*

314. *Id.*

315. *Id.* at 678-79.

316. *Id.* at 679.

317. I.R.C. § 197(e)(1)(A).

318. *Id.* § 197(e)(1)(B).

319. H.R. CONF. REP. NO. 213, *supra* note 173, at 679. See discussion *infra* part III.A.2.(a)(ii)(l).

320. H.R. CONF. REP. NO. 213, *supra* note 173, at 679 n.10.

321. I.R.C. § 197(e)(2).

322. H.R. CONF. REP. NO. 213, *supra* note 173, at 679.

routes, and cable television franchises are not considered interests in land under section 197.<sup>323</sup> The treatment of the costs of acquiring licenses, building and use permits, and other rights relating to land improvements remains unchanged by section 197.<sup>324</sup>

### c. Certain Computer Software

Any off-the-shelf computer software (i.e., software available to the general public, subject to a nonexclusive license, and not substantially modified) and other computer software which is not acquired in a transaction involving the acquisition of a business or a substantial portion thereof is excluded from the definition of a "section 197 intangible."<sup>325</sup> The term "computer software" is defined "as any program designed to cause a computer to perform a desired function."<sup>326</sup> "Computer software" includes "all incidental and ancillary rights . . . that (1) are necessary to effect the legal acquisition of the title to, and the ownership of, the computer software, and (2) are used only in connection with the computer software."<sup>327</sup> Further, "computer software" does not include any database or similar item that is in the public domain and is incidental to the software.<sup>328</sup>

If an amortization deduction is allowed for any computer software that is not a "section 197 intangible," such deduction shall be determined by amortizing the adjusted basis of the software ratably over thirty-six months, beginning with the month in which the software was placed in service.<sup>329</sup>

### d. Certain Interests in Films, Sound Recordings, Video Tape, Books, or Similar Property

If acquired separately (i.e., not acquired in a transaction involving the acquisition of assets constituting a trade or business or substantial portion thereof), any interest in films, sound recordings, video tapes, books, or similar property is excluded from the definition of a "section 197 intangible."<sup>330</sup> Interests such as licenses and rights to broadcast a live event also fall within the exclusion.<sup>331</sup>

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323. *Id.*

324. *Id.*

325. I.R.C. § 197(e)(3)(A).

326. *Id.* § 197(e)(3)(B).

327. H.R. CONF. REP. NO. 213, *supra* note 173, at 680.

328. I.R.C. § 197(e)(3)(B). A data base would not include a spell-check feature in word processing software. H.R. CONF. REP. NO. 213, *supra* note 173, at 680 n.12..

329. I.R.C. § 167(f)(1)(A) (Supp. V 1993).

330. I.R.C. § 197(e)(4)(A).

331. H.R. CONF. REP. NO. 213, *supra* note 173, at 680..

e. Certain Rights to Receive Tangible Property or Services

Rights to receive tangible property or services under a contract or by grant from the government are not "section 197 intangibles" if they are not acquired in a transaction (or series of related transactions) involving the acquisition of a trade or business or substantial portion thereof.<sup>332</sup> If such acquired property is not a "section 197 intangible" and an amortization deduction is allowed, then the amount of the deduction shall be made in accordance with forthcoming Treasury regulations.<sup>333</sup>

f. Certain Interests in Patents or Copyrights

Patents and copyrights not acquired in transactions involving the acquisition of assets constituting a trade or business are excluded from section 197 treatment.<sup>334</sup> Amortization deductions on excluded patents or copyrights must be taken in a manner consistent with regulations that the Treasury will issue.<sup>335</sup> The regulations likely will provide that if the purchase price of patents or copyrights is payable annually as a fixed percentage of the revenues derived from their use, the amount of the deduction will equal the annual payment.<sup>336</sup>

g. Interests Under Leases of Tangible Property

The term "section 197 intangible" does not include any interest as a lessor or lessee under an existing lease of tangible property, whether real or personal.<sup>337</sup> If an interest as a lessor is acquired in connection with the acquisition of tangible property subject to favorable existing leases, the portion of the purchase price attributable to the leases should be taken into account as a part of the basis of the property and depreciated accordingly.<sup>338</sup> Section 197 does not affect the treatment of "[t]he cost of acquiring an interest as a lessee under an existing lease of tangible property."<sup>339</sup> However, if an interest as a lessee under a lease of tangible property is acquired with other intangibles, the portion of the total purchase price properly allocable to the lessee's interest may not exceed "the present value of the fair market value rent for the use of the tangible

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332. I.R.C. § 197(e)(4)(B).

333. H.R. CONF. REP. NO. 213, *supra* note 173, at 680; *see also* I.R.C. § 197(g) (providing the Secretary of the Treasury with the authority to promulgate appropriate regulations).

334. I.R.C. § 197(e)(4)(C).

335. H.R. CONF. REP. NO. 213, *supra* note 173, at 681.

336. *Id.*

337. I.R.C. § 197(e)(5).

338. H.R. CONF. REP. NO. 213, *supra* note 173, at 681-82.

339. *Id.* at 682.; *see also* I.R.C. § 178 (1988) (amortization of lease acquisition costs) and Treas. Reg. § 1.162-11(a) (1993) (deductions for lease acquisition costs).

property for the term of the lease [reduced by] the present value of the rent reasonably expected to be paid for the use of the tangible property for the term of the lease."<sup>340</sup>

#### h. Interests Under Indebtedness

Except for acquired bank core deposits and similar items of financial institutions, any interest (whether as a debtor or creditor) in indebtedness existing on the date the interest was acquired is not a "section 197 intangible."<sup>341</sup> The treatment of the value of assuming existing debt with a below-market rate is not displaced by section 197.<sup>342</sup> Further, any premium paid for acquiring the right to receive an above-market rate of interest on debt is amortizable in accordance with Code section 171, "which generally allows the amount of the premium to be amortized on a yield-to-maturity basis over the remaining term of the debt instrument."<sup>343</sup>

#### i. Professional Sports Franchises

A franchise to engage in professional football, basketball, baseball, or other professional sport, and any item acquired in connection with such a franchise is excluded from section 197 treatment.<sup>344</sup> Thus, any goodwill associated with professional sports franchises is nonamortizable. Code section 1059 continues to govern the tax treatment of sports franchises.<sup>345</sup>

#### j. Certain Transaction Costs

The definition of a "section 197 intangible" does not encompass "fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C."<sup>346</sup> The legislative history reveals that this provision was included to address the concern that some taxpayers might argue that section 197's fifteen-year amortization period applies to amounts that are required to be capitalized but that do not relate to any asset with a determinable useful life.<sup>347</sup> More-

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340. H.R. CONF. REP. NO. 213, *supra* note 173, at 682.

341. I.R.C. § 197(e)(5)(B).

342. H.R. CONF. REP. NO. 213, *supra* note 173, at 682.

343. *Id.*

344. I.R.C. § 197(e)(6).

345. I.R.C. § 1059.

346. *Id.* § 197(e)(8). Section 351 (transfers to corporations owned by the transferors) and section 361 (corporate reorganizations) transactions are granted nonrecognition treatment and, accordingly, their associated transaction costs are not amortizable under section 197.

347. H.R. CONF. REP. NO. 213, *supra* note 173, at 683. See discussion *supra* part II.B.1.

over, although the transaction cost exclusion provision does not address the treatment of transaction costs associated with section 1032 exchanges and taxable acquisitions, the legislative history makes it clear that Congress did not intend any change in the treatment of transaction costs in other areas.<sup>348</sup>

k. Regulatory Authority Regarding Rights of Fixed Term or  
Fixed Duration

To the extent provided in regulations, which are to be promulgated by the Treasury, any right under a contract or granted by a governmental unit or an agency or instrumentality thereof is not a "section 197 intangible" if the right (1) is not acquired in a transaction that involves the acquisition of assets that constitute a trade or business, and (2) has a fixed duration of less than fifteen years, or has a fixed amount and would otherwise be recoverable under a method similar to the unit-of-production method.<sup>349</sup>

Congress anticipates that the regulations will provide that if a taxpayer has the opportunity to renew a contract or other right through a fair, competitive auction or similar process, the mere fact that the taxpayer has the opportunity to renew will not be taken into account in determining the duration of such contract or right or whether it is for a fixed amount.<sup>350</sup> The competitive bidding must, however, produce a fair market value price.<sup>351</sup> "Furthermore, it is expected that . . . the Treasury Department will take into account all the facts and circumstances, including [indications of] expectanc[ies] of renewals."<sup>352</sup> Renewal options and similar items, as well as the appropriate method of amortizing capitalized costs of contracts and other rights excluded from section 197 treatment under this provision should also be addressed in forthcoming regulations.<sup>353</sup>

1. Mortgage Servicing Rights

"Section 197 intangibles" do not include mortgage servicing rights secured by residential real property unless they are acquired in a transaction involving the acquisition of assets other than servicing rights that constitute a trade or business.<sup>354</sup>

Mortgage servicing rights, though excluded from section 197, are

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348. H.R. CONF. REP. NO. 213, *supra* note 173, at 683.

349. I.R.C. § 197(e)(4)(D).

350. H.R. CONF. REP. NO. 213, *supra* note 173, at 683.

351. *Id.*

352. *Id.*

353. *Id.* at 684.

354. I.R.C. § 197(e)(7).

amortizable on a straight-line basis over 108 months.<sup>355</sup> Thus, the mortgage banking industry's campaign for exclusion of mortgage servicing rights was arguably successful. Only those rights acquired in a business acquisition are amortizable over fifteen years; all other rights are amortizable over nine years. Before section 197, though, many mortgage servicing contracts were amortized more rapidly than straight-line over nine years.<sup>356</sup>

#### m. Certain Self-Created Intangibles

As a general rule, section 197 does not apply to any "section 197 intangible" that is created by the taxpayer.<sup>357</sup> Presumably this rule applies to any assets which would be "section 197 intangibles" but for being created by the taxpayer. There is an exception to this general rule if the "section 197 intangible" is created in connection with a transaction (or series of related transactions) that involves the acquisition of assets that constitute a trade or business. In such a case, the "self-created" intangible is not excluded.<sup>358</sup> Just what type of intangible would be created in this fashion is unclear.<sup>359</sup> Lastly, the exception for "self-created" intangibles does not apply to: (1) any license, permit, or other right granted by a governmental unit or agency or instrumentality thereof; (2) any covenant not to compete or similar arrangement entered into in connection with the direct or indirect acquisition of an interest in a trade or business; or (3) any franchise, trademark, or tradename.<sup>360</sup>

#### b. Section 197 as Curative Intangibles Legislation

Undeniably, section 197's most desirable attribute is its simplicity. Since most acquired intangibles, including goodwill, are now governed by a uniform fifteen-year cost recovery period, litigation over the allocation of purchase price premium and useful life will be dramatically reduced. Taxpayers have less incentive to allocate any purchase price premium away from goodwill and into shorter-lived intangible assets. In turn, the IRS will contest far fewer allocations. The following discussion generally focuses on the merits of section 197 as legislation designed to cure the recurring intangibles disputes between the IRS and taxpayers by establishing a uniform cost recovery period for most

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355. H.R. CONF. REP. NO. 213, *supra* note 173, at 694. Purchased mortgage servicing rights are not amortizable to the extent they are stripped coupons under section 1286. *Id.* at 694 n.33.

356. See discussion *supra* part III.A.1(a)(i).

357. I.R.C. § 197(c)(2).

358. *Id.*

359. Brode, *supra* note 148, at 1020.

360. I.R.C. § 197(c)(2)(A).

acquired intangibles and allowing amortization deductions for acquired goodwill.

i. Opting for a Single Recovery Period Instead of Multiple Cost Recovery Periods for the Sake of Simplicity

In adopting section 197's uniform fifteen-year cost recovery period, Congress opted for the simplicity of a noneconomic cost recovery approach enjoyed by tangible assets for decades. In so doing, Congress implicitly rejected the General Accounting Office's ("GAO's") suggestion that multiple cost recovery periods similar to those used for tangible assets be developed for intangible assets.<sup>361</sup>

A Congressional Research Service report maintained that the choice of a single amortization period generally does not result in tax rate distortions for intangible assets purchased as part of an ongoing business, and is therefore economically efficient.<sup>362</sup> The report also posited that although it may seem that tax neutrality—assuming no subsidies resulting from accelerated depreciation—would be obtained only through economic depreciation allowances, analogizing the economic depreciation of tangible assets with economic amortization of intangible assets is inapposite because of the Code's implicit preference for intangible capital expenditures.<sup>363</sup> Thus, economic theory appears to support Congress's rejection of the GAO's proposed use of multiple cost recovery classes and periods, because it simply was not necessary to achieve an economically efficient and tax-neutral result.

Further support for the application of a single, noneconomic life approach has been provided by tax professionals from both the public and private sectors. The Treasury's Assistant Secretary for Tax Policy, Fred Goldberg, Jr., maintained that a single recovery period was the "preferred regime" because intangibles, unlike tangibles, are difficult to define and value. Therefore, a single life approach should not only pre-

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361. See GAO REPORT, *supra* note 11, at 21, 33.

362. Jane G. Gravelle & Jack Taylor, *Taxing Intangibles: An Economic Analysis*, 91 TAX NOTES TODAY 219-31, Oct. 24, 1991, available in LEXIS, Taxria Library, TNT File [hereinafter CRS Report].

363. *Id.* The authors of the CRS report summarized the conclusion of their economic analysis before the House Ways and Means Committee, stating:

should Congress decide to legislate in [the intangibles] area, the administratively simple approach is also the neutral approach from an economic standpoint. Our study finds that uniform amortization periods for intangibles purchased as part of the sale of an ongoing business is the proper treatment to achieve uniform effective tax rates for different types of intangibles.

Jane G. Gravelle, *Congressional Research Service Official Testifies on Treatment of Intangibles*, 91 TAX NOTES TODAY 23-33, Oct. 30, 1991, available in LEXIS, Taxria Library, TNT File [hereinafter "CRS Statement"]. See also discussion *supra* part II.B.1. (noting the Code's implicit preference for intangible capital expenditures).



vent future controversies associated with lifing and valuing intangibles, but also improve administrability.<sup>364</sup> Similarly, the Chair of the American Bar Association's Section of Taxation, Peter L. Faber, strongly supported the use of one amortization period for all intangible assets despite possible mismatching in isolated transactions. He believed that such isolated distortions were preferable to the potential classification disputes, which are inevitable under a multiple class and period cost recovery system.<sup>365</sup>

It is precisely this isolated mismatching, inherent in the use of a single life cost recovery system, that should spark the most controversy. Allowing the amortization of purchased goodwill and similar intangibles that waste over time fosters increased matching in the tax system. Nonetheless, the application of a single life cost recovery approach necessarily results in *beneficial* mismatching for some and *detrimental* mismatching for others. Thus, the cost of the simplest approach is a mismatching of parts, notwithstanding any matched, nearly revenue-neutral whole.<sup>366</sup> The detrimentally mismatched taxpayers necessarily subsidize the activities of the beneficially mismatched, albeit a net-negative subsidy.

The General Accounting Office noted that the useful lives of intangibles claimed by taxpayers in the \$8 billion of disputed adjustments ranged from a low of 6.3 years for contract-based intangibles such as covenants not to compete, to a high of 10.6 years for statutory intangibles such as patents and copyrights.<sup>367</sup> The average claimed life was approximately eight years,<sup>368</sup> which is significantly less than Section 197's fifteen-year amortization period.

An unfortunate but necessary consequence of section 197's uniform amortization approach is that some intangibles bear the brunt of a prolonged cost recovery period. For example, under prior law, covenants

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364. *Hearings, supra* note 7, at 6 (testimony of Asst. Secretary Goldberg). Mr. Goldberg was Commissioner of Internal Revenue during hearings on House Bill 3035.

365. *Hearings, supra* note 7, at 115 (prepared statement of Peter L. Faber, Chair of the American Bar Association's Section of Taxation).

366. Section 197's 15-year amortization period is projected to generate about \$2.5 billion in tax revenues over five years. See Joint Committee on Taxation, *Staff Overview of Conference Agreement on Revenue Provisions of Omnibus Reconciliation Act of 1993*, 103d Cong., 1st Sess. (JCS-10-93) (1993), reprinted in *Daily Tax Rep. L-1, L-43* (Aug. 24, 1993).

367. GAO REPORT, *supra* note 11, at 25 table 3.4. The report posits that as of 1989, there were seven major categories of intangibles in dispute totalling approximately \$8 billion, of which \$4.1 billion related to customer-based or market-based intangibles such as core deposits and subscription lists, while \$3.9 billion related to other intangible assets (contract-based assets (\$1.2 billion), technology-based assets (\$665 million), patents and copyrights (\$341 million), workforce-based assets (\$886 million), acquisition costs, legal and auditing fees (\$358 million), and unidentified intangibles (\$498 million)). *Id.* at 3-4.

368. *Id.* at 25 table 3.4.

not to compete were generally written off over a three-year period. Under section 197, they must be amortized over fifteen years, even though they may be payable in only three years.<sup>369</sup> Congress was well aware that section 197 contained implicit timing-of-cost-recovery preferences,<sup>370</sup> but most cures have side effects. While the use of a multiple cost recovery period and method might have minimized disparities between the winners and the losers, the certainty and simplicity of a single life method were more important to the Treasury.<sup>371</sup>

Yet another justification for a single life approach was that due to favorable "carve-out" treatment for certain intangibles, such as computer software and mortgage servicing rights, and with the addition of an amortization allowance for acquired goodwill, a prolonged cost recovery period for some intangibles was necessary to maintain some semblance of revenue neutrality.<sup>372</sup> While it may be true that "carve-out" treatment for certain acquired intangibles can be likened to a multiple cost recovery system, such treatment is not as pervasive. Because the IRS should consider allocations to "carve-outs" suspect, any false purchase price premium allocations to such favored intangibles would most likely be detected upon audit.

Had Congress opted for a comprehensive multiple cost recovery system or, alternatively, had opted for intangibles legislation replete with favorable "carve-outs," disputes over the allocation of purchase price among acquired intangibles would inevitably have arisen as taxpayers attempted to overvalue certain intangibles and allocate costs to classes of intangibles with shorter recovery periods.<sup>373</sup> Consequently, under a multiple cost recovery system for intangibles, courts would still have been burdened with difficult facts and circumstances inquiries. On the other hand, the application of section 197's single cost recovery period of fifteen years reduces the incentive to misallocate purchase price among various acquired intangible assets, while removing the difficulties inherent in useful life approximations.

Some argue that a uniform recovery period does not address the taxpayer's incentive to allocate purchase price away from covenants not to compete and similarly affected intangibles to *tangible* assets that per-

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369. Brode, *supra* note 148, at 1019.

370. See generally *Hearings*, *supra* note 7; see also Brode, *supra* note 148, at 1019 n.41 and accompanying text.

371. *Hearings*, *supra* note 7, at 6-7.

372. See Kenneth J. Kies, *Should Goodwill Be Amortizable?—An Intoxicating Question!*, 52 TAX NOTES 1649, 1651-52 (1991) (recognizing the need for an extended cost recovery period due to the inclusion of an amortization allowance for goodwill); Kenesey, *supra* note 50, at 876-77 (noting that the computer software exception to section 197 was necessary despite its strain on revenue neutrality).

373. Helmich, *supra* note 188, at 991.

mit a shorter cost recovery period.<sup>374</sup> It would be ironic if section 197 caused the IRS and taxpayers to reverse roles—the IRS arguing for greater allocation to “section 197 intangibles” and taxpayers arguing for increased allocation to acquired tangibles.

However, such a shift in the pre-section 197 allocative dispute is improbable. Although highly aggressive taxpayers who manage to escape audit may get away with distorted allocations, their chances for continued success are slim. Allocation is driven by the fair market value of each acquired asset.<sup>375</sup> Due largely to a more developed tangibles market, inflated tangible asset valuations are more readily detectable and contestable than exaggerated intangible asset valuations. Thus, artificial allocations could not withstand IRS scrutiny over time.

ii. Curing the Allocative Dispute with Respect to Goodwill—  
Implicating The Timing of Cost Recovery for Intangible  
Expenditures

Section 197's inclusion of an amortization allowance for acquired goodwill was necessary to obtain the greatest degree of simplification in the tax treatment of intangibles.<sup>376</sup> Under prior law, the taxpayer had the often irresistible incentive to allocate as little as possible of the purchase price of a business to goodwill because goodwill was nonamortizable *per se*. This incentive caused taxpayers to undertake complicated and costly appraisals in order to identify and attempt to amortize intangible assets other than goodwill, even though such assets were inextricably linked to goodwill. Further, taxpayers became rather imaginative in creating new types of intangibles to which purchase price could be allocated in an attempt to escape the nonamortizability of goodwill.<sup>377</sup>

The IRS was also burdened by the nonamortizability of goodwill. In its study of pending intangibles cases between 1979 and 1987, the GAO found that in seventy percent of the cases in which taxpayers claimed that intangible assets had a determinable useful life, the IRS argued that the assets were goodwill and not amortizable.<sup>378</sup>

Allowing the amortization of goodwill should minimize allocational disputes. Because the amortization period is the same for goodwill and other “section 197 intangibles,” the taxpayer has little incentive to allocate purchase price either to or from goodwill.<sup>379</sup>

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374. See, e.g., Brode, *supra* note 148, at 1019-20.

375. See discussion *supra* part II.B.2.

376. See generally Kies, *supra* note 372.

377. See Laura Saunders, *A Little Too Creative*, FORBES, July 23, 1990, at 66.

378. See *supra* notes 81-82 and accompanying text.

379. For tax purposes, goodwill is defined as “the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a

Nevertheless, permitting the amortization of purchased goodwill necessarily raises questions of whether a more accurate reflection of income will result. It may be argued that goodwill is not a wasting asset, so the allowance of amortization deductions for acquired goodwill results in an understatement of income.<sup>380</sup> Alternatively, it may be argued that because the costs associated with maintaining the value of goodwill are currently deductible, amortization of the costs of acquired goodwill is not required in order to accurately measure income.

For example, assume that a taxpayer acquires all of the assets of a business, including goodwill, and thereafter incurs advertising expenditures that in part preserve, or perhaps even enhance, the value of the purchased goodwill. Under prior law, the amortization of the acquired goodwill was disallowed. However, advertising expenditures were, and remain, currently deductible. It could be argued that the pre-section 197 regime properly measured income because, even assuming that goodwill is a wasting asset, the currently deducted costs restore the value of the goodwill. The theoretical basis for this argument is that expenses attributable to recovering lost goodwill should be capitalized and amortized over the life of the goodwill and that insofar as prior law did not require such treatment, denying the amortization for goodwill is, therefore, appropriate even though goodwill is a wasting intangible.

Many tax professionals maintain, however, that goodwill is in fact a wasting asset, and therefore the section 197 tax treatment of acquired goodwill is proper.<sup>381</sup> Given the broad definition of goodwill, it is logical to assume that goodwill loses value over time. Clearly, a business that enjoys customer loyalty is more valuable than a business that does not. But customer loyalty, unfortunately, does not last forever. Customers may relocate, die, or change preferences.<sup>382</sup> Perpetual competition for market share between businesses inevitably shifts the customer base.

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trade or business, the reputation of a trade or business, or any other factor." H.R. CONF. REP. NO. 213, *supra* note 173, at 674.

380. See Kies, *supra* note 372 (noting that the question of whether goodwill should be amortizable is "intoxicating").

381. See, e.g., GAO REPORT, *supra* note 11, at 5, 33 (the economic reality is that goodwill does waste over time); Mundstock, *supra* note 29, at 1188, 1234 (economic evidence indicates that goodwill is a wasting asset although determining its useful life is often difficult); NYSBR, *supra* note 111, at 944 ("[w]hile we are not economists, we believe that in many, if not all, cases acquired goodwill and going concern value are wasting assets with a limited economic life (even though that life can be difficult to predict in advance)"); Schenck, *supra* note 48, at 522 ("the rule for purchased goodwill like the rule for created goodwill should recognize that, while the exact life span of goodwill cannot be reckoned with actuarial certainty, goodwill has a limited life.") (quoting Robert J. McDonald, *Goodwill and the Federal Income Tax*, 45 VA. L. REV. 645 (1959)).

382. See *Harvard Note*, *supra* note 39, at 864 ("Large expenditures for research and advertising give credence to the proposition that loyalty and preference are short run phenomena. . .").

Accepting the logical contention that goodwill generally is a wasting intangible, allowing current deductions for costs that may contribute to the replacement of wasting goodwill does not justify denying amortization deductions for acquired goodwill. Granted, the current deductibility of most expenditures incurred to create or preserve intangible assets results in anomalies. For example, acquirers of goodwill and other "section 197 intangibles" are bound by a fifteen-year cost recovery period, whereas creators of goodwill and other intangibles and purchasers of some intangibles excluded from section 197 may possibly recover their costs faster. However, section 197 did not create this disparity. Arguably, permitting amortization of acquired goodwill will more closely equate the tax treatment of the creator and the purchaser of intangibles, including goodwill, than did prior law.<sup>383</sup>

It could be argued that because section 197 promotes matching by recognizing that goodwill and other intangibles are wasting assets and allowing their amortization when purchased, the Code should promote further matching by recognizing another economic reality, namely, that some currently deductible expenses such as advertising costs either create assets with lives extending beyond the current year, increase the value of such assets, or aid in the production of income for more than one year and, therefore, should be capitalized and amortized.<sup>384</sup> Legislative recognition of the former economic reality without recognition of the latter may have been appropriate.<sup>385</sup> Section 197 is a revenue generator for the Treasury.<sup>386</sup> Moreover, section 197 was a simplification provision that will greatly reduce disputes between the IRS and taxpayers. Legislative recognition of the latter economic reality "would, unless done in an arbitrary manner, create exactly the kind of controversies in the area of expenses that [section 197] is designed to end in the area of purchased intangibles."<sup>387</sup>

In addition, an arbitrary capitalization requirement for a fixed percentage of certain types of expenses, such as advertising, is ill-advised.<sup>388</sup> Such a rule would unfairly penalize businesses whose applicable expenditures are relatively level over time and are not incurred to expand business into new territories or products.<sup>389</sup> Section 197's fifteen-year amortization period for acquired intangibles is more acceptable—despite elements of "rough justice"—because it applies only to

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383. NYSBR, *supra* note 111, at 964.

384. *Id.* See also discussion *supra* part II.B.1. (capitalization).

385. *Id.*

386. See *supra* note 366.

387. NYSBR, *supra* note 111, at 964.

388. *Id.* at 964-65.

389. *Id.* at 965.

relatively infrequent and discrete transactions in which the rule can be considered when setting the purchase price.<sup>390</sup> Conversely, “[a]n arbitrary rule for expenses deemed in part to be attributable to self-created intangibles would be much broader in application—it would adversely affect every ongoing business in the country, and such businesses would not have any opportunity to offset the loss of deductions by a mechanism such as a purchase price adjustment.”<sup>391</sup>

Fortunately, Congress opted for simplicity in adopting section 197, thereby avoiding the inescapable morass that would certainly engulf any attempt at substantial modification of the tax rules for recovering current expenditures.

### iii. Reducing Transaction Costs—But at Acceptable Costs?

Because it creates certainty and simplicity, section 197 should also reduce the transaction costs associated with business acquisitions and thereby lead to a more efficient allocation of investment income among competing investment alternatives. Still, opponents of section 197 argue that although simplicity yields predictable tax results, other arguably undesirable consequences—such as increased mergers and acquisitions activity, including leveraged buyouts and hostile takeovers—are inevitable.

Senator Paul Simon stated that section 197 “provide[s] a tax subsidy that [will] fuel new activity in mergers and acquisitions and [will] further weaken the economy and overall unemployment.”<sup>392</sup> Representative Kostmayer labeled the merger mania of the 1980s economically “devastating” and found it “unbelievable [that] the United States tax code encourages and subsidizes such behavior.”<sup>393</sup>

While a reduction in costs may very well promote corporate acquisitions, the high transaction costs associated with the pre-section 197 regime do not represent sound tax policy.<sup>394</sup> Assuming that a social policy of discouraging corporate acquisitions is sound, retaining a tax system marked by high transaction costs would be an irrational way to implement this policy.<sup>395</sup> Retaining a system of high transaction costs would “promote economic waste and would not distinguish between potentially beneficial acquisitions and acquisitions considered harmful.”<sup>396</sup> Notably, the pre-section 197 tax treatment of intangibles did not

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390. *Id.*

391. *Id.*

392. Kirchheimer, *supra* note 10, at 973 (quoting Sen. Simon).

393. Kitchel, *supra* note 8 (quoting Rep. Peter H. Kostmayer).

394. *Id.*

395. *Id.*

396. *Id.*

have a discernable regulatory effect on M&A activity.<sup>397</sup> Intangible asset values reported by corporations actually grew from \$45 billion in 1980 to \$262 billion in 1987, primarily due to growth in M&A activity during the period.<sup>398</sup>

Some commentators do not share the concern that section 197 will stimulate a spate of undesirable mergers and acquisitions.<sup>399</sup> These advocates maintain that insofar as "the tax law influences the pace of corporate takeovers, [section 197's amortization period] for almost all intangibles, even though goodwill is included, may be neutral or even act as a restraint on acquisitions."<sup>400</sup> But, these same proponents qualify their assertion, stating:

Any such restraint would, of course, be diluted if the number of exceptions from the uniform intangible amortization period were to proliferate. More importantly, perhaps, each exception will create a new area of controversy as taxpayers seek to maximize and the IRS to minimize the allocation of value to the excepted intangibles. Indeed, if there are numerous exceptions to the general rule, the desired simplification will not be achieved."<sup>401</sup>

As previously discussed, section 197 gives preferential treatment to certain acquired intangibles by excluding them from the definition of "section 197 intangibles."<sup>402</sup> While there may be legitimate justifications for the exclusion of such intangibles from section 197's "rough justice" approach,<sup>403</sup> it is nevertheless troubling because other assets are sure to follow, thus jeopardizing section 197's simplicity and legitimacy. In recognition of these concerns, the Treasury Department is to conduct a study of the implementation and effects of section 197, including its effects on mergers and acquisitions, and to report these findings to Congress no later than December 31, 1994.<sup>404</sup>

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397. *Id.*

398. See GAO REPORT, *supra* note 11, at 10.

399. See, e.g., *Bar Association Urges Enactment of Intangible Asset Legislation*, 93 TAX NOTES TODAY 109-19, May 21, 1993, available in LEXIS, Taxria Library, TNT File (letter from Richard G. Cohen, Chairman of the Council on Taxation of the Association of the Bar of the City of New York to House Ways and Means Committee Chairman Rostenkowski).

400. *Id.*

401. *Id.*

402. See discussion *supra* part III.A.2(a)(i).

403. See, e.g., Helmich, *supra* note 188, at 991 (noting that frequent innovations in the computer industry necessitate the computer software exception, and that further exceptions might sacrifice the revenue neutrality of section 197); Kenesey, *supra* note 50, at 872-73 (recognizing the importance of the computer software exception insofar as it allows the U.S. software industry to retain its competitive lead).

404. H.R. CONF. REP. NO. 213, *supra* note 173, at 696.

## IV. CONCLUSION

Section 197 should effectively cure the controversy over acquired intangible assets, which was pervasive under prior law. The judiciary was correct when it stated that intangibles reform was properly a matter for legislative attention. Congress's "simple" solution was the appropriate cure for the controversy over the amortization of acquired intangible assets. Section 197 will substantially eliminate disputes between taxpayers and the IRS with respect to (1) allocation of purchase price between acquired goodwill and other intangibles by affording most acquired intangibles, including goodwill, the same tax treatment and (2) useful life determinations for purchased intangibles by subjecting the bulk of such assets to a uniform fifteen-year cost recovery period.

While some taxpayers are harmed by the introduction of a noneconomic and, in some cases, preferential cost recovery system for acquired intangibles, the prior law's tax treatment was too burdensome and inequitable. Section 197's objective uniform cost recovery approach modernizes the tax law on acquired intangibles at acceptable costs, at least for now.

The simplicity of section 197 is its most salient attribute. This simplicity reduces inequities to taxpayers, uncertainty in tax planning, and administrative costs. But should there be more "carve-outs" from section 197 to provide closer economic life approximations, to subsidize favored industries, or to create questionable M&A regulation through tax reform, then the taxpayers, the IRS, and the judiciary may face a rebirth of the intangibles quandary.

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