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AMORTIZATION OF INTANGIBLE ASSETS IN A BUSINESS ACQUISITION

Section 197 sets a firm amortization period for acquired intangibles, but the method of allocating purchase price to those assets remains somewhat problematic, despite recent Regulations.

SHELDON D. POLLACK, Attorney

When the assets of an existing business are purchased in an asset acquisition, important tax issues arise for the buyer. Traditionally, one of the most contentious has been the question of how to allocate the total purchase price among the various acquired assets. Of special concern is the purchase price that is allocated to intangible assets—in particular, goodwill and going concern value.

Throughout most of the history of the income tax, goodwill and going concern value have been nondepreciable; the buyer was not allowed to amortize these assets for tax purposes. As a result, the buyer would not receive any tax benefit through future depreciation deductions for the purchase price allocated to goodwill and going concern value. A tax benefit would be realized, if ever, only on a subsequent resale of the business. Because of this, the allocation of purchase price to intangible assets in a business acquisition has been an issue of great concern.

Taxpayers and the IRS very often have different notions as to how much of the purchase price should be allocated to these acquired intangibles. Notwithstanding decades of litigation, multiple amendments to the Code, and an abundance of Regulations, most of the controversy remains.

In 1993, the Supreme Court joined the fray when it addressed one specific manifestation of this recurring problem—namely, whether that portion of the purchase price allocated to customer-based intangible assets is amortizable for tax purposes. In *Newark Morning Ledger*, [1] the Court answered with a resounding "yes," at least in certain limited circumstances. Soon after, Congress responded by adding Section 197 to the Code as a part of RRA '93.

This statute effectively rendered the Supreme Court's decision moot, as it mandates an entirely new tax treatment for customer-based intangible assets, along with *all* other intangible assets. Under the new treatment, most acquired intangible assets—including goodwill and going concern value—may be amortized over 15 years.

Goodwill and going concern value

The buyer of a business often pays more for the business assets as a going concern than it would

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for the very same "hard" assets purchased separately. Of course, the reason for such an act of fiscal extravagance is that the seller has already put the individual assets together into that abstract entity known as a "business." A going concern business includes more than just the collective sum of the tangible assets, and presumably is worth the extra purchase price precisely because it comes with such things as loyal customers, existing contracts, trained employees, and general know-how. These are precisely what the buyer needs most and is willing to pay a premium for.

This premium (i.e., the excess of the total purchase price over the FMV of the individual hard assets) relates to what is by definition an intangible asset. For lack of a better term, this intangible asset traditionally has been referred to as goodwill or going concern value. These terms have no "real" existence and are merely words used to describe the excess payment made for the hard assets of a business. Problems arise when these intangibles are accounted for in the same manner as tangible assets.

Cost recovery. One of the ways to account for *tangible* business assets is to amortize their purchase price. Section 167(a) generally permits depreciation deductions for assets used in a trade or business, whether the assets are purchased individually or collectively as a going concern. The intent of this provision is to allow the business to amortize the purchase price of its "wasting" assets by means of depreciation deductions that offset future income produced with these assets. Taxable income will most clearly reflect the underlying economic reality of a trade or business, or investment activity, when depreciation deductions are matched in the same accounting periods with the income attributable to the productive use of the business' assets.

Despite the general rule allowing depreciation for business assets, the IRS long ago took the position that goodwill and going concern value are *not* amortizable assets to the extent that they are not subject to exhaustion or wear and tear. This also is the Service's position with respect to self-created goodwill. To the extent that a business does not have basis in its self-created goodwill, however, this has little importance. On the other hand, when a business acquires the goodwill or going concern value of another business (e.g., a premium is paid for the business's hard assets), not being allowed to claim depreciation deductions can have a significant impact.

Useful life. A business that buys a new asset generally knows what it paid, and hence, knows its cost basis in the asset. To calculate depreciation or amortization deductions, however, the asset's useful life must be determined. In the past, this determination was often subject to dispute as it involves a highly subjective assessment.

In 1981, Congress replaced the system of basing amortization on the estimated useful life of the asset with a system of statutory recovery periods based on the classification of assets into a relatively few and certain categories. Under current law, an acquired asset must be classified into one of those statutory recovery periods provided under the Modified Accelerated Cost Recovery System (MACRS).[2]

Basis. The taxpayer, however, still must know the cost basis of all business assets. Thus, when a business is acquired as a going concern, the new owner must ascertain the cost basis of each particular asset to claim the appropriate depreciation deduction in subsequent tax years. This is done by allocating the total purchase price among the various assets that comprise the acquired business. How the total purchase price is allocated among the various assets affects the total depreciation deductions allowable to the buyer in subsequent years.

To the extent that intangible assets in the nature of goodwill and going concern value are nondepreciable, purchasers of a going concern traditionally would go to great lengths to allocate as much as possible of the total purchase price to depreciable assets—both tangible and intangible, but in either event, to assets with a short recovery period—and as little as possible to goodwill and going concern value. Obviously, this was done to avoid the considerably less favorable tax consequences that would result from allocating greater amounts of purchase price to the nondepreciable intangible assets. Similarly, allocations to nondepreciable tangible property (such as land) also would be avoided or minimized.

WITH TAX INCENTIVES BEING POWERFUL TOOLS FOR ALTERING HUMAN BEHAVIOR, TAXPAYERS SHRINK FROM ALLOCATING PURCHASE PRICE TO NONDEPRECIABLE ASSETS.

With tax incentives being powerful tools for altering human behavior, taxpayers shrink

from allocating purchase price to nondepreciable assets—whether goodwill, going concern value, or land. This elementary fact accounts much for the long history of litigation between purchasers of businesses and the IRS; the latter, not surprisingly, often objects to a buyer's self-serving allocations. Of course, it is not so much the *method* of allocation that bothers the IRS as it is the *outcome*—namely, the inflation of the value of the acquired depreciable assets and the corresponding understatement of the value of the nondepreciable intangible assets, goodwill and going concern value.

The statutory responses to this conflict have mostly focused on the method of allocating purchase price among the various acquired assets. Undoubtedly, this is why the statutory solutions enacted over the years have contributed so little to ending the disputes.

Applicable asset acquisition

In an effort to resolve the decades of litigation between taxpayers and the IRS over the allocation of purchase price in the acquisition of a going concern business, Congress added Section 1060 in 1986.[3] The legislative history to Section 1060 indicates an express intention to end the controversy by prescribing the *method* for allocating purchase price among the acquired assets.[4]

The rationale behind Section 1060 was that if the buyer were required to use an "objective" method of allocating purchase price among the acquired assets, the correct portion of purchase price would be allocated to the respective assets, including goodwill and going concern value. When the correct portion of the purchase price is allocated to depreciable assets, the buyer is limited to the appropriate depreciation deductions. To attain this worthy goal, Congress selected the residual method as the most appropriate method for allocating purchase price among the acquired assets and mandated its use under Section 1060.

UNDER THE RESIDUAL METHOD, THE TOTAL PURCHASE PRICE MUST BE ALLOCATED AMONG SEPARATE CATEGORIES OR 'CLASSES' OF ASSETS.

Scope of Section 1060. Section 1060 applies to any "applicable asset acquisition." An applicable asset acquisition is the acquisition, whether directly or indirectly, of assets constituting a trade or business and with respect to which the "transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets." [5] Basically, this means that the business assets are acquired in a taxable sale or exchange—as opposed to a nontaxable acquisition, such as a merger or liquidation of a subsidiary.

Residual method. With an applicable asset acquisition, the buyer must allocate the total purchase price among the various acquired assets using the residual method.[6] The residual method originally applied to corporate liquidations under former Sections 332 and 334(b)(2). Thereafter, the residual method was adopted to stock purchases treated for tax purposes as an asset acquisition under Section 338 (i.e., stock purchases treated as asset acquisitions). [7] The drafters of Section 1060 simply borrowed the residual method from the Section 338 Regulations and applied it to applicable asset acquisitions.[8]

Under the residual method (prior to Regulations discussed below), the total purchase price must be allocated among four separate categories or "classes" of assets:

- Class I assets consist of cash, demand deposits, and similar items.
- Class II assets are certificates of deposit, U.S. government securities, readily marketable securities, etc.
- Class III assets are all other assets (tangible and intangible) other than Class I, II, and IV assets.
- Class IV are intangible assets in the nature of goodwill and going concern value.

Under the residual method, purchase price is allocated first to Class I assets, then to Class II, III, and IV assets, respectively, according to the FMV of the assets within each class as of the purchase date.[9] After purchase price is allocated to Class I, II, and III assets, whatever is left is allocated to the residual Class IV assets—goodwill and going concern value. (On the other hand, if the aggregate allocated to a class is less than the FMV of the assets in that class, the allocation to each of that class' assets is made in proportion to its FMV.)

Points of contention. While Section 1060 provides this method for allocating purchase price, there still remains significant grounds for disagreement between taxpayers and the IRS. Specifically, while the valuation of Class I and II assets is fairly straightforward, there is still

much room for disagreement over the *value* of the Class III assets. Once again, controversy arises because the very act of valuing assets is highly subjective—notwithstanding the pretensions of the drafters of the residual method. Indeed, the very classification and existence of an asset within that class is often debatable.

Under the new Section 1060 regime (at least, prior to enactment of Section 197), the battleground shifted as taxpayers and the IRS would find themselves disagreeing over allocations between Class III and Class IV assets. In an asset acquisition governed by Section 1060, the buyer has a strong incentive to allocate as much as possible of the total purchase price to depreciable tangible (Class III) property, as well as to "discover" some valuable depreciable intangible assets distinguishable from the goodwill and going concern value of the acquired business.[10] These would include such intangible assets as valuable leasehold interests, licensing agreements, employment agreements, covenants not to compete, patents, copyrights, subscription lists, and customer lists.

As noted above, for an intangible asset to be depreciable, it generally must have a readily ascertainable and limited useful life.[11] Reg. 1.167(a)-3 states that "[i]f 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." Arguably, it is possible to determine with reasonable accuracy the useful life of intangible assets such as the aforementioned leasehold interests, licensing agreements, employment agreements, covenants not to compete, patents, copyrights, subscription lists, and customer lists.

When some extra portion of the total purchase price could be allocated to the intangible asset, and the asset has a determinable and limited useful life, the buyer could amortize that amount of the purchase price over that period. This would necessarily be preferable to an allocation of the same amount of the total purchase price to goodwill or going concern value.

Once again, incentives were created that induce buyers to shift purchase price among assets. Unfortunately, some taxpayers always yield to temptation. Those who do so will overestimate the value of their acquired depreciable intangible assets, thereby minimizing the allocation to the nondepreciable residual Class IV assets.

Thus, the bickering between taxpayers and the IRS over purchase price allocations continues. Of course, this is inevitable as the underlying issue is one of *valuation* of nonpublicly traded property, and not the *method* of allocating the purchase price. Section 1060 adopts a pseudo-scientific method that on first glance appears to eliminate any basis for disagreement, but in reality merely shifts the grounds for dispute. Still, adopting Section 1060 was not without benefit. At least, the statute forces the parties to focus their attention on the same issue—the *value* of the various acquired assets.

SECTION 1060 FORCES THE PARTIES TO FOCUS THEIR ATTENTION ON THE SAME ISSUE—THE *VALUE* OF THE VARIOUS ACQUIRED ASSETS.

Section 197

Attempting to resolve the ongoing conflict over allocations of purchase price to acquired intangible assets, Section 197 prescribes a 15-year recovery period for *all* "amortizable intangible assets" acquired in the acquisition of a business. Although acquired goodwill and going concern value now unquestionably qualify for amortization, the recovery period is considerably longer than that previously used for many of the depreciable intangible assets to which it applies.

Goodwill is the value of a trade or business attributable to the expectancy of continued patronage; going concern value is the additional value of the assets of a trade or business that attaches by being part of a going concern. Intangible assets covered by Section 197 also include customer-based intangibles (such as subscription lists), supplier-based intangibles, work-force in place, know-how, information base, governmental licenses and permits, covenants not to compete, trademarks, trade names, franchises, and contracts for the use of the preceding items.

Intangibles that do not fall within the definition of Section 197 intangible assets continue to be treated as they had been before that provision's enactment. For example, Section 197(e)(5) exempts any interest in an existing lease (whether from the lessor or lessee's perspective) from treatment as a Section 197 intan-

Some intangibles excluded from Section 197 coverage continue to be treated as they had been prior to the enactment of Section 197. For example, Section 197(e)(5) exempts any interest in an existing lease (whether as a lessor or lessee). That asset is amortizable over the remaining term of the acquired leasehold interest. Therefore, it remains advantageous for a buyer to allocate purchase price up to FMV to such an acquired Class III asset to the extent that the remaining term of such lease is shorter than the 15-year recovery period under Section 197.

gible. That asset is amortizable over the remaining term of the acquired leasehold interest. Thus, it remains advantageous for a buyer to allocate purchase price up to FMV to such an acquired Class III asset to the extent that the remaining term of the lease is shorter than the 15-year Section 197 recovery period.

Useful life irrelevant. Obviously, under this Section 197 regime, there is no longer any need to determine, whether with "reasonable accuracy" or otherwise, the useful life of acquired intangible assets. The simple rule is that these assets can be amortized over 15 years. The good news for taxpayers is that this includes goodwill and going concern value; the bad news is that for intangible assets with a readily ascertainable useful life of *less* than 15 years (such as most covenants not to compete and customer-based intangibles like subscription lists), the statutory recovery period can be less favorable.

This adverse tax effect can make an investment in businesses such as newspapers and magazines (the most valuable asset of which may be the publication's subscription list) much less attractive. Because the purchase price allocated to such assets must be amortized over 15 years, there is a very real cost to the buyer. Obviously, this will adversely affect the after-tax rate of return the buyer realizes on its investment.

Impact. The impact of Section 197 on the typical transaction can be significant—sometimes for the better, sometimes for the worse. Under the statute, all acquired Section 197 intangible assets (such as prepaid subscriptions or customer-based intangibles) must be amortized over 15 years, even if they have a shorter ascertainable useful life.

Likewise, there is no longer any incentive for the buyer to allocate any amount of the purchase price to a collateral covenant not to compete or "consulting" agreement entered into with the seller. Whatever the agreement's term, as a Section 197 intangible, it must be amortized over 15 years along with the other Section 197 intangible assets. Because the seller must recognize the amounts received under a covenant or consulting agreement as ordinary income (potentially taxed at a maximum rate of 39.6%, as opposed to the 28% rate that applies to long-term capital gains), there is little incentive under current law to shift any of the purchase price paid for the business assets to such collateral agreements. In this respect, Section 197 has had a positive effect by eliminating the incentives to make this type of questionable allocation.

Proposed Regulations

In January 1997, the Service published Proposed Regulations concerning the amortization of intangible assets under Sections 167(f) and 197.[12] The IRS also issued final, Temporary, and Proposed Regulations concerning purchase price allocations with respect to intangible assets acquired in an asset acquisition governed by Section 1060 and stock acquisitions treated as asset acquisitions under Section 338.[13] Under the Regulations, intangible assets subject to Section 197 are broadly defined to include most intangible assets acquired in connection with the acquisition of a trade or business, and certain other separately acquired intangible assets. The new Regulations make changes that conform with the tax treatment of intangible assets prescribed by RRA '93.

The Section 197 Proposed Regulations generally apply to taxpayers who, in connection with the acquisition of a trade or business, acquire intangible assets after 8/10/93, or made a retroactive election to apply Section 197 to intangible assets acquired after 7/25/91. The Regulations under Sections 338 and 1060 generally apply to acquisitions after 2/13/97.

Excluded intangibles. The Proposed Regulations provide guidance for the tax treatment of certain intangible assets specifically excluded from Section 197 treatment. Such "excluded intangible assets" include computer software, rights to receive property or services, patents, copyrights, other rights for a fixed term, and mortgage servicing rights.[14]

Stock and partnership interests also are among those intangible assets excluded from Section 197 treatment.[15] According to the Preamble to the Proposed Regulations, stock and partnership interests are not subject to an

allowance for depreciation because such property "represents a permanent investment that can only be recovered through disposition of the asset (including worthlessness)." For intangible property such as computer software, purchased mortgage servicing rights, service and supply contracts, and certain other contracts or rights with a fixed duration, other cost recovery methods were prescribed under RRA '93.

Section 167(f) contains alternative methods of depreciation for some intangibles excluded from the application of Section 197. The Section 167(f) Proposed Regulations provide rules for intangible property subject to the allowance for depreciation and specifically excluded from Section 197. In some instances, the depreciation method deemed "most appropriate under the circumstances" may be more favorable than Section 197 treatment, providing a new incentive to shift more of the purchase price to such excluded intangible assets.

Prop. Reg. 1.197-2(h) also provides rules to prevent taxpayers from converting goodwill, going concern value, or any other Section 197 intangible acquired prior to the effective date of the new provision, into a "new" Section 197 asset for which 15-year amortization is allowed. These anti-churning rules prevent taxpayers from transferring nondepreciable intangible assets to a related party (e.g., a brother-sister corporation) in order to create a new amortizable Section 197 intangible asset.

Likewise, Prop. Reg. 1.197-2(j) contains an anti-abuse provision that allows the Service to recharacterize any transaction if one of its principal purposes is to avoid Section 197 treatment. It is unclear whether this provision allows the Service to recharacterize a transaction the principal purpose of which is to *secure* Section 197 treatment (for instance, by "discovering" some new acquired intangible asset and allocating purchase price to it, thereby reducing the allocation to land). This kind of transaction may actually turn out to offer the greater potential for abuse.

Purchase price allocations. The new final, Temporary, and Proposed Regulations also address issues raised in purchase price allocations. Basically, the Regulations account for depreciable Section 197 intangible assets in the allocation scheme mandated for asset acquisitions under Section 1060 and stock acquisitions to which Section 338 applies. As described above, the allocation method prescribed for both applicable asset acquisitions and deemed asset acquisitions requires that purchase price be allocated (according to the FMV of the assets within each class) to the acquired assets by segregating assets into the four classes.

Temp. Reg. 1.1060-1T(d) amends this allocation scheme by allocating all Section 197 assets, other than goodwill and going concern value, to Class IV. Goodwill and going concern value are allocated to a new "true residual class," known as Class V. (The IRS has not yet amended Form 8594 to include new Class IV. Temp. Reg. 1.1060-1T(h)(3) states that until Form 8594 is amended, Class V assets should be lumped together with the Class IV assets.) As Class V assets, goodwill and going concern value are amortizable over the same 15-year period as other Section 197 intangibles in Class IV. Therefore, the new allocation scheme has no substantive tax consequences. Basically, the Regulations just tidy things up a bit and make the allocation scheme more conceptually pleasing to the eye of the tax professional.

Definitions. Prop. Reg. 1.197-2(b)(1) defines goodwill pretty much as before. Goodwill is "the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor." A bit more detail is given to the definition of going concern value, which is "the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity.

Going concern value, defined in Prop. Reg. 1.197-2(b)(2), includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership.... It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational."

THE REGULATIONS JUST TIDY THE ALLOCATION RULES UP A BIT AND MAKE THE SCHEME MORE CONCEPTUALLY PLEASING TO THE EYE OF THE TAX PROFESSIONAL.

None of this is new. Goodwill and going concern value are what is left over after all the pur-

chase price has been allocated to the hard assets based on their FMVs.

Buyer-seller consistency. Finally, the new Proposed Regulations strengthen the requirement in Section 1060(a)(2) that the buyer and seller report their allocations consistently when the parties have included a written allocation in the purchase agreement. The new rule requires that the parties also include the same assets in the same classes.

Conclusion

After many efforts by Congress and the IRS to end the decades of litigation concerning purchase price allocations in business acquisitions involving intangible assets, the controversy continues. The method prescribed under Section 1060 initially offered hope. Section 1060 mandates a rational and orderly method for allocating purchase price among the acquired assets. Likewise, Section 197 creates a more sensible and less contentious method of treating acquired intangibles. It may, however, be time to acknowledge that whatever the initial optimism, these statutes simply cannot solve the problem at its root. Casting the problem as one of method is the inherent flaw in the system.

The dispute really involves a question of *valuation*. As such, it cannot be resolved by requiring buyers (and sellers) to use some pseudo-scientific method of allocating the purchase price among the various acquired assets, as Section 1060 attempts. This merely shifts the grounds for disagreement. For instance, buyers of a newspaper still have an incentive to allocate as much as possible of the total purchase price to equipment and trucks (assets depreciable over seven and five years, respectively) so as to reduce the magnitude of the allocation to Section 197 intangibles (amortizable over 15 years), buildings (depreciable over 39 years) and land (nondepreciable).

Furthermore, under the regime created by Sections 197 and 1060, it is now preferable to allocate purchase price to goodwill, going concern value, and customer-based intangibles, rather than to buildings and land. So long as there are different recovery periods for different assets—and so long as there are significant differences in the length of these recovery periods—there will be an incentive to make allocations based on self-serving valuations and classifications of assets purchased in a business acquisition. When Congress stretches the recovery period for commercial buildings to nearly 40 years (for no other reason than to squeeze some additional tax revenue out of businesses), then taxpayers will shy away from allocating purchase price to that property in preference to assets with shorter recovery periods—including the once feared intangibles: goodwill and going concern value.

If only land and a building are purchased, buyers will seek to allocate as much of the purchase price to the building and as little as possible to the nondepreciable land. This happens even if Section 1060 does not apply.

What is in essence a problem of determining the true value of assets acquired in mass (rather than purchased separately in discrete market transactions) cannot be solved by methods such as that required under Sections 338 and 1060. On the other hand, the logic underlying Section 197 makes considerable sense. Eliminating great disparities between recovery periods reduces the incentive to shift the value among the acquired assets. When the purchase price is great enough and even a minimal disparity remains between recovery periods, however, incentives to skew allocations remain. Therefore, tax disputes concerning acquired intangibles will continue. ■

NOTES

[1] 507 U.S. 546, 71 AFTR2d 93-1380 (S.Ct., 1993).

[2] Section 168.

[3] See Schler, "Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10) and More," 43 Tax Law Rev. 605 (Summer 1988).

[4] S. Rep't No. 99-313, 99th Cong., 2d Sess. 254 (1986).

[5] Section 1060(c).

[6] Section 1060(a).

[7] See Section 338(b)(5).

[8] Note 4, *supra*.

[9] Temp. Reg. 1.1060-1T(e)(1).

[10] See Wyndelts and Fowler, "Avoiding Allocations to Goodwill Under the Asset-Acquisition Rules," 71 TA 392 (December 1989).

[11] Houston Chronicle Publishing Co., 481 F.2d 1240, 32 AFTR2d 73-5312-A (CA-5, 1973), *cert. den.*; Rev. Rul. 74-456, 1974-2 CB 65.

[12] REG-209709-94, 1/9/97. See Metzer, "Intellectual Property Acquisitions Under New Prop. Regs.," page 4, this issue; Melone, "Section 197 Complicates Planning for Retiring LLC Members," page 11, this issue.

[13] REG-252665-95; TD 8711, 1/9/97.

[14] Section 197(e); Prop. Regs. 1.197-2(c)(4), (6), (7), (11), and (13); Prop. Reg. 1.167(a)-14.

[15] Section 197(e)(1).