INTELLECTUAL PROPERTY

AMORTIZATION

and the

ENTREPRENEUR

(with PRACTITIONER ANNEX)

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by Donald L. Lader Jr. '95

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INTELLECTUAL PROPERTY, AMORTIZATION AND THE ENTREPRENEUR
INFORMATION YOU SHOULD KNOW
(with Practitioner's Annex)

by Donald L. Lader Jr.

INTRODUCTION

Russell L. Parr, in the January 1995 issue of Investment Risk and Royalty Rates, made the following statement. "Without intellectual property, a company cannot differentiate itself and must fight in a commodity oriented environment where competition is fierce and profit margins are slim. Intellectual property can make the difference between being stuck in a commodity market and enjoying fast growth and high profit margins." Such is the power of Intellectual Property.

The existence of Intellectual Property has been shown for many years in the accounting records as "goodwill." In many cases, the value assigned to goodwill was higher than all the other company assets. This value was always static, thus violating the accounting principle that the accounting records should reflect the true value of the company. The value of "goodwill," as with any asset, rose and fell yet was never accounted for. On August 10, 1993, the U.S. Congress passed the Revenue Reconciliation Act of 1993, adding Section 197 to the Internal Revenue Code. This section provides for the amortization of goodwill and several other types of Intellectual Property. This paper will discuss Section 197 and the potential for finding value for the entrepreneur.

This paper is divided into three sections. The first section will introduce the reader to specialized terminology used within this document and well as some basic accounting terms. The second section will be a discussion of Section 197. The final section will be the Practitioner's Annex. This section will provide references to the CPA or lawyer to other relevant sections of the Internal Revenue Code, current issues under discussion and an example of how the court looks at Section 197.

DEFINITIONS

The following list of definitions is intended to provide the reader with enough knowledge to interpret this paper correctly. Since this paper may be read by a variety of people with different business backgrounds, I have defined some words that may seem obvious to some readers. Even if you are familiar with these terms, it is suggested that you read the definitions provided since these indicate how the terms are used in this paper.

Tangible Property: property that has physical form and substance, that which may be felt or touched, although it may be either real or personal.

Intangible Property: property that has no intrinsic and marketable value, but is merely the representative or evidence of value, it lacks physical existence and can only exist in connection with something else.

Amortization: the allocation (and charge to expense) of the cost or other basis of an intangible asset over its estimated useful life. Intangible assets which have an indefinite life are normally not amortizable.

Section 197 Intangibles: intangible assets acquired and held in connection with the conduct of a trade or business or an activity engaged in for the production of income after August 10, 1993.

Amortization Period: for Section 197 intangibles, 15 years utilizing the straight-line method.

SECTION 197

As described in the Internal Revenue Code, Section 197 intangibles would normally include those general intangibles acquired at the time a business is purchased. It would also apply to those general intangibles purchased separately after the business is acquired. In most cases, intangibles that are self-created would be excluded. Exceptions do exist to these general rules. Some of these exceptions will be discussed later.

Amortization is the term used to refer to the depreciation or depletion of an intangible asset. The theory is that as an asset is used over time, its value declines. A simple example is that of a modern automobile. Each year, as the vehicle gets older, its value on the market is less than its original value. Amortization is done to adjust the value of the intangible asset to reflect its true value over time. Under Section 197, all Section 197 intangibles are deemed to have a fifteen-year lifetime. Within these fifteen years, it is assumed that the value will decrease equally each year. This is referred to as the straight-line method of amortization. The beginning of the fifteen-year period is the month the intangible is acquired.

EXAMPLE:	Cost to acquire:	$15,000.00
	Useful life:	15 Years
	Loss Per Year:	($15,000 / 15) = $1,000.00
	Therefore: there is a yearly amortization amount of $1,000 per year	

The importance of amortization to the business owner cannot be understated. The amortization allowance ($1,000 per year in the example) is treated as an expense to the company. As such, this becomes a deduction to revenue. As with other expenses, this amount is deducted before any tax calculations are made. Therefore, amortization of intangibles provide a new cost expense deduction to the company. You may only take this deduction once per year. Section 197(b) prevents any other depreciation or amortization deduction for the same Section 197 intangible.

The Internal Revenue Code provides a list of what a "Section 197 Intangible" actually is. This list is shown is Table 1. A discussion of each listed item will follow.

A	Goodwill and Going Concern Value
B	Workforce in Place
C	Business Information Base
D	Intellectual Property and Know-how
E	Customer-based Intangibles
F	Supplier-bases Intangibles
G	Other Similar Items
H	Government Licenses and Permits
I	Covenants Not To Compete
J	Franchises, Trademarks, and Trade Names

Table 1

A - Goodwill is the value attributable to the expectancy that customers will continue to patronize the transferred business due to its reputation, name, or some other factor. The going concern value is that value inherent in a business that exists solely because the business operating structure is already in place.

B - It is recognized that a trained and experienced workforce has value and therefore this is included as a Section 197 intangible. Included also would be the value from the terms and conditions of existing employment contracts and the acquisition of employment contracts.

C - Every business has records that are essential to its operations. Included in this category are business books and records, operating systems, customer lists, technical manuals, training materials, data files and accounting and inventory control systems.

D - Included in this category are any patent, copyright, formula, process, design, pattern, know-how, format, package design and other similar items. Unless one of the noted exceptions below applies, acquired computer software, interest in a film, sound recording, video tape, book or similar interest is included.

E - Customer-based intangibles are those items acquired from interaction with customers. Examples are the value of customer lists, the current market share, the composition of the market, the undeveloped market and market growth potential. Some insurance contracts also fall into this category. It is important to note that rights to income from services or goods already provided (accounts receivable) are not included.

F - The supplier-based intangibles are the reciprocal of the customer-based intangibles. Examples of items in this category are long-term purchase contracts with favorable prices, contracts for favorable shelf space and the credit rating of the business with the supplier.

G - This category is a catchall provision. The purpose is to ensure that no acquired intangible that was intended to have a fifteen year life for amortization purposes is

omitted. This provision also allows for future development of intangibles similar to those categorized above to be included.

H - Some businesses require permits from Government entities. The acquisition of these permits may involve a large expense both in time and money. In recognition of this and the fact that after it is acquired the permit has value, Section 197 allows for these costs to be capitalized. Once capitalized, they may be amortized as a Section 197 intangible.

I - Covenants not to compete are agreements, usually between the seller of a business and the buyer of the business. The purpose is to prevent the seller from immediately opening up a new competing business in the same marketing area. Section 197 recognizes the value of such an agreement. There are several rules and conditions that must be met before these costs may be considered Section 197 intangibles. This is due to the potential of abuse in this area and the Internal Revenue Service will scrutinize these agreements before allowing a deduction.

J - This area is a direct change to Section 1253 of the Internal Revenue Code. Under Section 197, the costs incurred to create, acquire, or renew franchises, trademarks, and trade names are to be amortized over a fifteen-year period. This provision does not discuss the deduction of payments made for use of these items. These deductions are still controlled by Section 1253(d)(1) of the Internal Revenue Code.

The Internal Revenue Code also provides a list of what a "Section 197 Intangible" is not. This list is shown in Table 2. Only a discussion of self-created intangibles will follow, however, each item on the list should be investigated to assure that it does not qualify as the asset is currently held.

A	Interest in Land
B	Computer Software (important exceptions)
C	Lease of Tangible Property
D	Interest Under Existing Debt
E	Sports Franchise
F	Mortgage Servicing Rights
G	Transaction Costs
H	Self-Created Intangibles

Table 2

With the exception of Government Licenses and Permits and Franchises, Trademarks and Trade Names in Table 1, Section 197 does not apply to assets created by the business owner. This restriction is expanded to include those intangibles created by a person hired by the business owner if the contract with the person was entered into prior to the creation of the intangible asset. These intangibles may still be eligible for amortization under other sections of the Internal Revenue Code. The Self-Created Intangibles category does not exclude those intangibles created in connection with a

transaction to acquire the assets of a trade or business nor does it exclude the costs associated with the renewal of a contract or license to use a recognized Section 197 intangible.

NOTED EXCEPTIONS

While Section 197 normally applies to intangible assets acquired separately, there are four noted exceptions. These exceptions only denote that the items are not to be treated as "Section 197 Intangibles." Other sections of the Internal Revenue code may provide for the amortization or depreciation of these assets.

The first exception is for any interest in a film, sound recording, video tape, book or similar property. These items are normally depreciable under Sections 168(f)(3), 168(f)(4) and Section 167. Nothing in the Internal Revenue Code has changed to disallow depreciation under these sections.

The second exception is for any right to receive tangible property or services under a contract or granted by a Government entity. There is not a set rule for the possible depreciation of this tangible property. An investigation into the contract may lead to a method of depreciation or amortization under the Internal Revenue Code.

The third exception is for any interest in a patent or copyright. These items are currently under review by the Internal Revenue Service (as of March 1995). The issue does not appear to be whether these items are to be amortized but rather, what is the proper method of amortization. The reader should consult current rules and regulations to determine if depreciation or amortization is available elsewhere in the Internal Revenue Code, such as Section 167. It is important to remember that self-created patent costs can currently be deducted under Section 174(a) as a research and development expenditure or they may be amortized under Section 174(b).

The fourth and final exception is for any right received under a contract or granted by the Government that has a fixed duration of less than fifteen years, or is fixed in amount, and is of a type that could be recovered using a units-of-production method. The details of this type of exception is beyond the scope of this paper. The reader should consult professional advice to make a determination of the issues in question.

FINAL NOTE

In a final note, the reader should be reminded that the initial value placed on Section 197 property will be closely scrutinized by the Internal Revenue Service. The actual valuation of intangible property is a complex process. The reader should not attempt to set their own value to this type of property unless they have had training in valuation techniques. The cost of obtaining professional help for the valuation process will be easily recaptured by the savings made by avoiding an Internal Revenue Service challenge in the future.

PRACTITIONER ANNEX

This Practitioner Annex is designed to provide guidance for accountants and lawyers involved with Section 197 intangibles. The goal is to provide pointers to other relevant sections of the Internal Revenue Code and to provide some insight to problems that have been encountered under Section 197 (Appendix A). At the time of the writing of this paper (April 1995), very little guidance has been provided either by the Internal Revenue Service or the courts.

RELATED CODE SECTIONS

Other areas of the Internal Revenue Code that should be considered in a Section 197 analysis are shown in Table A.

§§	AREA OF INTEREST
332	Complete Liquidation of Subsidiaries
351	Transfer to Corporation Controlled by Transferor
361	Nonrecognition of Gain or Loss to Corporations; Treatment of Distributions
721	Nonrecognition of Gain or Loss on Contribution
731	Extent of Recognition of Gain or Loss on Distribution
754	Manner of Electing Optional Adjustment to Basis of Partnership Property
755	Rules For Allocation of Basis
1031	Exchange of Property Held For Productive Use or Investment
1033	Involuntary Conversions
1060	Special Allocation Rules For Certain Asset Acquisitions
1221	Capital Asset Defined
1231	Property Used in the Trade or Business and Involuntary Conversions
1239	Gain From Sale of Depreciable Property Between Certain Related Taxpayers
1245	Gain From Dispositions of Certain Depreciable Property

TABLE A

Each of these sections should be consulted for additional guidance in any given transaction. They cover such issues as the valuation of assets at the time of their acquisition (§ 1060), whether the asset should be treated as a capital asset (§§ 1221, 1231, 1245, 1239), how Section 197 intangibles are treated in nonrecognition transactions (§§ 332, 351, 361, 721, 731, 1031, 1033) and how Section 197 intangibles may be treated in partnership transactions (§§ 754, 755). As with any Internal Revenue Code provision, the practitioner should ensure that all information used is current.

DISPOSITION

Another area of concern occurs upon the disposition of Section 197 intangibles. Gain and loss may be recognized, but only if all the intangibles acquired in the original purchase are disposed of. In this case, a loss for one intangible may be carried over to the remaining intangibles. Any gain must also be recognized. While "goodwill" can be

amortized in bulk, these requirements make it clear that each intangible must be assigned a separate value and each intangible's basis must be tracked. Even more finite rules have been developed for covenants not to compete and similar arrangements. The practitioner should consult current rulings in this area.

ELECTION PERIOD

The Internal Revenue Service has provided guidance for Section 197 intangibles that were acquired after July 25, 1991 but before the effective date of Section 197, August 10, 1993. This guidance has been formalized at 26 CFR 1.197-1T, Certain elections for intangible property (temporary). Appendix B of this paper is a copy of this section current through the March 24, 1995 issue of the Federal Register. The practitioner should consult later editions before making a final decision on Section 197 intangible elections.

ANTI-CHURNING RULES

Section 197(f)(9) contains the anti-churning rules. The purpose of the rules are to prevent a sale of qualifying assets simply for the purpose of obtaining Section 197 intangible status. This section has for its primary focus those past intangibles that may now qualify as Section 197 intangibles. At the present time, the Internal Revenue Service has not issued any rulings or guidance in this area. The practitioner should consult current regulations whenever the issue involves potential Section 197 intangibles in a purchase or sale transaction. Until such guidance is provided by the Internal Revenue Service, a Private Letter Ruling may be advisable.

THE COURT

At the time of this writing, one court has discussed Section 197, and then only in a footnote. The actual issue in question involved Section 167 of the Internal Revenue Code. See Ithaca Industries, Inc., Petitioner-Appellant v. Commissioner of Internal Revenue, 17 F.3d 684 (1994), attached as Appendix C.

In this case, the issue was whether an assembled workforce qualified as a depreciable asset. The court held that the life of the workforce in question had no reasonably ascertainable limits and therefore the depreciation was not allowed.

This case was decided based on the analysis in Newark Morning Ledger. See Newark Morning Ledger Co. v. United States, 113 S.Ct. 1670 (1993), attached as Appendix D. The critical decision was whether the workforce in question was self regenerating or if there was a substantial effort required to maintain the workforce, with the later producing "new" elements. In the later result, the workforce may be depreciated under a Newark Morning Ledger analysis.

This case has been included in this paper to introduce the practitioner the problems that existed in the past. A careful reading of Section 197 will show that an assembled workforce is a Section 197 intangible. However, as footnote 6 in Ithaca Industries states, this is a 1983 case. If Section 197 had been in effect, the only issue that

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could have been raised in this case would be the initial value assigned to the assembled workforce. Clearly, Section 197 has the potential to eliminate many issues that were problematic under Section 167.

APPENDIX A

INTERNAL REVENUE CODE

*** THIS SECTION IS CURRENT THROUGH P.L. 103-336, APPROVED 10/3/94 ***

SUBTITLE A. INCOME TAXES

CHAPTER 1. NORMAL TAXES AND SURTAXES

SUBCHAPTER B. Computation of Taxable Income

PART VI. Itemized Deductions for Individuals and Corporations

IRC Sec. 197 (1995)

Sec. 197. Amortization of goodwill and certain other intangibles.

(a) General rule.

A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

(b) No other depreciation or amortization deduction allowable.

Except as provided in subsection (a), no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 intangible.

(c) Amortizable section 197 intangible.

For purposes of this section --

(1) In general. Except as otherwise provided in this section, the term "amortizable section 197 intangible" means any section 197 intangible --

(A) which is acquired by the taxpayer after the date of the enactment of this section, and

(B) which is held in connection with the conduct of a trade or business or an activity described in section 212.

(2) Exclusion of self-created intangibles, etc. The term "amortizable section 197 intangible" shall not include any section 197 intangible --

(A) which is not described in subparagraph (D), (E), or (F) of subsection (d)(1), and

(B) which is created by the taxpayer.

This paragraph shall not apply if the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(3) Anti-churning rules. For exclusion of intangibles acquired in certain transactions, see subsection (f)(9). (d) Section 197 intangible.

For purposes of this section --

(1) In general. Except as otherwise provided in this section, the term "section 197 intangible" means --

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

(iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and

(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in

connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

(F) any franchise, trademark, or trade name.

(2) Customer-based intangible.

(A) In general. The term "customer-based intangible" means --

(i) composition of market,

(ii) market share, and

(iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

(B) Special rule for financial institutions. In the case of a financial institution, the term "customer-based intangible" includes deposit base and similar items.

(3) Supplier-based intangible. The term "supplier-based intangible" means any value resulting from future acquisitions 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.

(e) Exceptions.

For purposes of this section, the term "section 197 intangible" shall not include any of the following:

(1) Financial interests. Any interest --

(A) in a corporation, partnership, trust, or estate, or

(B) under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract.

(2) Land. Any interest in land.

(3) Computer software.

(A) In general. Any --

(i) computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and

(ii) other computer software which is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(B) Computer software defined. For purposes of subparagraph (A), the term "computer software" means any program designed to cause a computer to perform a desired function. Such term shall not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

(4) Certain interests or rights acquired separately. Any of the following not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion thereof:

(A) Any interest in a film, sound recording, video tape, book, or similar property.

(B) Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof.

(C) Any interest in a patent or copyright.

(D) To the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right --

(i) has a fixed duration of less than 15 years, or

(ii) is fixed as to amount and, without regard to this section, would be recoverable under a method similar to the unit-of-production method.

(5) Interests under leases and debt instruments. Any interest under --

(A) an existing lease of tangible property, or

(B) except as provided in subsection (d)(2)(B), any existing indebtedness.

(6) Treatment of 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.

(7) Mortgage servicing. Any right to service indebtedness which is secured by residential real property unless such right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than rights described in this paragraph) constituting a trade or business or substantial portion thereof.

(8) Certain transaction costs. Any 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.

(f) Special rules.

(1) Treatment of certain dispositions, etc.

(A) In general. If there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained --

(i) no loss shall be recognized by reason of such disposition (or such worthlessness), and

(ii) appropriate adjustments to the adjusted bases of such retained intangibles shall be made for any loss not recognized under clause (i).

(B) Special rule for covenants not to compete. In the case of any section 197 intangible which is a covenant not to compete (or other arrangement) described in subsection (d)(1)(E), in no event shall such covenant or other arrangement be treated as disposed of (or becoming worthless) before the disposition of the entire interest described in such subsection in connection with which such covenant (or other arrangement) was entered into.

(C) Special rule. All persons treated as a single taxpayer under section 41(f)(1) shall be so treated for purposes of this paragraph.

(2) Treatment of certain transfers.

(A) In general. In the case of any section 197 intangible transferred in a transaction described in subparagraph (B), the transferee shall be treated as the transferor for purposes of applying this section with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

(B) Transactions covered. The transactions described in this subparagraph are --

(i) any transaction described in section 332, 351, 361, 721, 731, 1031, or 1033, and

(ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

(3) Treatment of amounts paid pursuant to covenants not to compete, etc. Any amount paid or incurred pursuant to a covenant or arrangement referred to in subsection (d)(1)(E) shall be treated as an amount chargeable to capital account.

(4) Treatment of franchises, etc.

(A) Franchise. The term "franchise" has the meaning given to such term by section 1253(b)(1).

(B) Treatment of renewals. Any renewal of a franchise, trademark, or trade name (or of a license, a permit, or other right referred to in subsection (d)(1)(D)) shall be treated as an acquisition. The preceding sentence shall only apply with respect to costs incurred in connection with such renewal.

(C) Certain amounts not taken into account. Any amount to which section 1253(d)(1) applies shall not be taken into account under this section.

(5) Treatment of certain reinsurance transactions. In the case of any amortizable section 197 intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible under this section shall be the excess of --

(A) the amount paid or incurred by the acquirer under the assumption reinsurance transaction, over

(B) the amount required to be capitalized under section 848 in connection with such transaction.

Subsection (b) shall not apply to any amount required to be capitalized under section 848.

(6) Treatment of certain subleases. For purposes of this section, a sublease shall be treated in the same manner as a lease of the underlying property involved.

(7) Treatment as depreciable. For purposes of this chapter, any amortizable section 197 intangible shall be treated as property which is of a character subject to the allowance for depreciation provided in section 167.

(8) Treatment of certain increments in value. This section shall not apply to any increment in value if, without regard to this section, such increment is properly taken into account in determining the cost of property which is not a section 197 intangible.

(9) Anti-churning rules. For purposes of this section --

(A) In general. The term "amortizable section 197 intangible" shall not include any section 197 intangible which is described in subparagraph (A) or (B) of subsection (d)(1) (or for which depreciation or amortization would not have been allowable but for this section) and which is acquired by the taxpayer after the date of the enactment of this section, if --

(i) the intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,

(ii) the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or

(iii) 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 25, 1991, and on or before such date of enactment.

For purposes of this subparagraph, the determination of whether the user of property changes as part of a transaction shall be determined in accordance with regulations prescribed by the Secretary. For purposes of this subparagraph, deductions allowable under section 1253(d) shall be treated as deductions allowable for amortization.

(B) Exception where gain recognized. If --

(i) subparagraph (A) would not apply to an intangible acquired by the taxpayer but for the last sentence of subparagraph (C)(i), and

(ii) the person from whom the taxpayer acquired the intangible elects, notwithstanding any other provision of this title --

(I) to recognize gain on the disposition of the intangible, and

(II) to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest rate of income tax applicable to such person under this title,

then subparagraph (A) shall apply to the intangible only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized under clause (ii)(I).

(C) Related person defined. For purposes of this paragraph --

(i) Related person. A person (hereinafter in this paragraph referred to as the "related person") is related to any person if --

(I) the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1), or

(II) the related person and such person are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1)).

For purposes of subclause (I), in applying section 267(b) or 707(b)(1), "20 percent" shall be substituted for "50 percent".

(ii) Time for making determination. A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

(D) Acquisitions by reason of death. Subparagraph (A) shall not apply to the acquisition of any property by the taxpayer if the basis of the property in the hands of the taxpayer is determined under section 1014(a).

(E) Special rule for partnerships. With respect to any increase in the basis of partnership property under section 732, 734, or 743, determinations under this paragraph shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.

(F) Anti-abuse rules. The term "amortizable section 197 intangible" does not include any section 197 intangible acquired in a transaction, one of the principal purposes of which is to avoid the requirement of subsection (c)(1) that the intangible be acquired after the date of the enactment of this section or to avoid the provisions of subparagraph (A).

(g) Regulations.

The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including such regulations as may be appropriate to prevent avoidance of the purposes of this section through related persons or otherwise.

HISTORY:

In ' 93, P.L. 103-66, Sec. 13261(a), added Code Sec. 197, effective for property acquired after 8/10/93, except as provided in Sec. 13261(g)(2) and (3) of this Act, which reads as follows:

"(2) Election to have amendments apply to property acquired after July 25, 1991.

"(A) In general. If an election under this paragraph applies to the taxpayer --

"(i) the amendments made by this section shall apply to property acquired by the taxpayer after July 25, 1991,

"(ii) subsection (c)(1)(A) of section 197 of the Internal Revenue Code of 1986 (as added by this section) (and so much of subsection (f)(9)(A) of such section 197 as precedes clause (i) thereof) shall be applied with respect to the taxpayer by treating July 25, 1991, as the date of the enactment of such section, and

"(iii) in applying subsection (f)(9) of such section, with respect to any property acquired by the taxpayer on or before the date of the enactment of this Act, only holding or use on July 25, 1991, shall be taken into account.

"(B) Election. An election under this paragraph shall be made at such time and in such manner as the Secretary of the Treasury or his delegate may prescribe. Such an election by any taxpayer, once made --

"(i) may be revoked only with the consent of the Secretary, and

"(ii) shall apply to the taxpayer making such election and any other taxpayer under common control with the taxpayer (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of such Code) at any time after August 2, 1993, and on or before the date on which such election is made.

"(3) Elective binding contract exception.

"(A) In general. The amendments made by this section shall not apply to any acquisition of property by the taxpayer if --

"(i) such acquisition is pursuant to a written binding contract in effect on the date of the enactment of this Act and at all times thereafter before such acquisition,

"(ii) an election under paragraph (2) does not apply to the taxpayer, and

"(iii) the taxpayer makes an election under this paragraph with respect to such contract.

"(B) Election. An election under this paragraph shall be made at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe. Such an election, once made --

"(i) may be revoked only with the consent of the Secretary, and

"(ii) shall apply to all property acquired pursuant to the contract with respect to which such election was made."

APPENDIX B

*** THIS SECTION IS CURRENT THROUGH THE 3/24/95 ISSUE OF ***

*** THE FEDERAL REGISTER ***

TITLE 26 -- INTERNAL REVENUE

CHAPTER I -- INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

SUBCHAPTER A -- INCOME TAX

PART 1 -- INCOME TAXES

NORMAL TAXES AND SURTAXES

COMPUTATION OF TAXABLE INCOME

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

26 CFR 1.197-1T

§ 1.197-1T Certain elections for intangible property (temporary).

(a) In general. This section provides rules for making the two elections under section 13261 of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93). Paragraph (c) of this section provides rules for making the section 13261(g)(2) election (the retroactive election) to apply the intangibles provisions of OBRA '93 to property acquired after July 25, 1991, and on or before August 10, 1993 (the date of enactment of OBRA '93). Paragraph (d) of this section provides rules for making the section 13261(g)(3) election (binding contract election) to apply prior law to property acquired pursuant to a written binding contract in effect on August 10, 1993, and at all times thereafter before the date of acquisition. The provisions of this section apply only to property for which an election is made under paragraph (c) or (d) of this section.

(b) Definitions and special rules -- (1) Intangibles provisions of OBRA '93. The intangibles provisions of OBRA '93 are sections 167(f) and 197 of the Internal Revenue Code (Code) and all other pertinent provisions of section 13261 of OBRA '93 (e.g., the amendment of section 1253 in the case of a franchise, trademark, or trade name).

(2) Transition period property. The transition period property of a taxpayer is any property that was acquired by the taxpayer after July 25, 1991, and on or before August 10, 1993.

(3) Eligible section 197 intangibles. The eligible section 197 intangibles of a taxpayer are any section 197 intangibles that --

(i) Are transition period property; and

(ii) Qualify as amortizable section 197 intangibles (within the meaning of section 197(c)) if an election under section 13261(g)(2) of OBRA '93 applies.

(4) Election date. The election date is the date (determined after application of section 7502(a)) on which the taxpayer files the original or amended return to which the election statement described in paragraph (e) of this section is attached.

(5) Election year. The election year is the taxable year of the taxpayer that includes August 10, 1993.

(6) Common control. A taxpayer is under common control with the electing taxpayer if, at any time after August 2, 1993, and on or before the election date (as defined in paragraph (b)(4) of this section), the two taxpayers would be treated as a single taxpayer under section 41(f)(1) (A) or (B).

(7) Applicable convention for sections 197 and 167(f) intangibles. For purposes of computing the depreciation or amortization deduction allowable with respect to transition period property described in section 167(f) (1) or (3) or with respect to eligible section 197 intangibles --

(i) Property acquired at any time during the month is treated as acquired as of the first day of the month and is eligible for depreciation or amortization during the month; and

(ii) Property is not eligible for depreciation or amortization in the month of disposition.

(8) Application to adjustment to basis of partnership property under section 734(b) or 743(b). Any increase in the basis of partnership property under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) or section 743(b) (relating to the optional adjustment to the basis of partnership property) will be taken into account under this section by a partner as if the increased portion of the basis were attributable to the partner's acquisition of the underlying partnership property on the date the distribution or transfer occurs. For example, if a section 754 election is in effect and, as a result of its acquisition of a partnership interest, a taxpayer obtains an increased basis in an intangible held through the partnership, the increased portion of the basis in the intangible will be treated as an intangible asset newly acquired by that taxpayer on the date of the transaction.

(9) Former member. A former member of a consolidated group is a corporation that was a member of the consolidated group at any time after July 25, 1991, and on or before August 2, 1993, but that is not under common control with the common parent of the group for purposes of paragraph (c)(1)(ii) of this section.

(c) Retroactive election -- (1) Effect of election -- (i) On taxpayer. Except as provided in paragraph (c)(1)(v) of this section, if a taxpayer makes the retroactive election, the intangibles provisions of OBRA '93 will apply to all the taxpayer's transition period property. Thus, for example, section 197 will apply to all the taxpayer's eligible section 197 intangibles.

(ii) On taxpayers under common control. If a taxpayer makes the retroactive election, the election applies to each taxpayer that is under common control with the electing taxpayer. If the retroactive election applies to a taxpayer under common control, the intangibles provisions of OBRA '93 apply to that taxpayer's transition period property in the same manner as if that taxpayer had itself made the retroactive election. However, a retroactive election that applies to a non-electing taxpayer under common control is not treated as an election by that taxpayer for purposes of re-applying the rule of this paragraph (c)(1)(ii) to any other taxpayer.

(iii) On former members of consolidated group. A retroactive election by the common parent of a consolidated group applies to transition period property acquired by a former member while it was a member of the consolidated group and continues to apply to that property in each subsequent consolidated or separate return year of the former member.

(iv) On transferred assets -- (A) In general. If property is transferred in a transaction described in paragraph (c)(1)(iv)(C) of this section and the intangibles provisions of OBRA '93 applied to such property in the hands of the transferor, the property remains subject to the intangibles provisions of OBRA '93 with respect to so much of its adjusted basis in the hands of the transferee as does not exceed its adjusted basis in the hands of the transferor. The transferee is not required to apply the intangibles provisions of OBRA '93 to any other transition period property that it owns, however, unless such provisions are otherwise applicable under the rules of this paragraph (c)(1).

(B) Transferee election. If property is transferred in a transaction described in paragraph (c)(1)(iv)(C)(1) of this section and the transferee makes the retroactive election, the transferor is not required to apply the intangibles provisions of OBRA '93 to any of its transition period property (including the property transferred to the transferee in the transaction described in paragraph (c)(1)(iv)(C)(1) of this section), unless such provisions are otherwise applicable under the rules of this paragraph (c)(1).

(C) Transactions covered. This paragraph (c)(1)(iv) applies to --

(1) Any transaction described in section 332, 351, 361, 721, 731, 1031, or 1033; and

(2) Any transaction between corporations that are members of the same consolidated group immediately after the transaction.

(D) Exchanged basis property. In the case of a transaction involving exchanged basis property (e.g., a transaction subject to section 1031 or 1033) --

(1) Paragraph (c)(1)(iv)(A) of this section shall not apply; and

(2) If the intangibles provisions of OBRA '93 applied to the property by reference to which the exchanged basis is determined (the predecessor property), the exchanged basis property becomes subject to the intangibles provisions of OBRA '93 with respect to so much of its basis as does not exceed the predecessor property's basis.

(E) Acquisition date. For purposes of paragraph (b)(2) of this section (definition of transition period property), property (other than exchanged basis property) acquired in a transaction described in paragraph (c)(1)(iv)(C)(1) of this section generally is treated as acquired when the transferor acquired (or was treated as acquiring) the property (or predecessor property). However, if the adjusted basis of the property in the hands of the transferee exceeds the adjusted basis of the property in the hands of the transferor, the property, with respect to that excess basis, is treated as acquired at the time of the transfer. The time at which exchanged basis property is considered acquired is determined by applying similar principles to the transferee's acquisition of predecessor property.

(v) Special rule for property of former member of consolidated group -- (A) Intangibles provisions inapplicable for certain periods. If a former member of a consolidated group makes a retroactive election pursuant to paragraph (c)(1)(i) of this section or if an election applies to the former member under the common control rule of paragraph (c)(1)(ii) of this section, the intangibles provisions of OBRA '93 generally apply to all transition period property of the former member. The intangibles provisions of OBRA '93 do not apply, however, to the transition period property of a former member (including a former member that makes or is bound by a retroactive election) during the period beginning immediately after July 25, 1991, and ending immediately before the earlier of --

(1) The first day after July 25, 1991, that the former member was not a member of a consolidated group; or

(2) The first day after July 25, 1991, that the former member was a member of a consolidated group that is otherwise required to apply the intangibles provisions of OBRA '93 to its transition period property (e.g., because the common control election under paragraph (c)(1)(ii) of this section applies to the group).

(B) Subsequent adjustments. See paragraph (c)(5) of this section for adjustments when the intangibles provisions of OBRA '93 first apply to the transition period property of the former member after the property is acquired.

(2) Making the election -- (i) Partnerships, S corporations, estates, and trusts. Except as provided in paragraph (c)(2)(ii) of this section, in the case of transition period property of a partnership, S corporation, estate, or trust, only the entity may make the retroactive election for purposes of paragraph (c)(1)(i) of this section.

(ii) Partnerships for which a section 754 election is in effect. In the case of increased basis that is treated as transition period property of a partner under paragraph (b)(8) of this section, only that partner may make the retroactive election for purposes of paragraph (c)(1)(i) of this section.

(iii) Consolidated groups. An election by the common parent of a consolidated group applies to members and former members as described in paragraphs (c)(1)(ii) and (iii) of this section. Further, for purposes of paragraph (c)(1)(ii) of this section, an election by the common parent is not treated as an election by any subsidiary member. A retroactive election cannot be made by a corporation that is a subsidiary member of a consolidated group on August 10, 1993, but an election can be made on behalf of the subsidiary member under paragraph (c)(1)(ii) of this section (e.g., by the common parent of the group). See paragraph (c)(1)(iii) of this section for rules concerning the effect of the common parent's election on transition period property of a former member.

(3) Time and manner of election -- (i) Time. In general, the retroactive election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the election year. If, however, the taxpayer's original Federal income tax return for the election year is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994.

(ii) Manner. The retroactive election is made by attaching the election statement described in paragraph (e) of this section to the taxpayer's original or amended income tax return for the election year. In addition, the taxpayer must --

(A) Amend any previously filed return when required to do so under paragraph (c)(4) of this section; and

(B) Satisfy the notification requirements of paragraph (c)(6) of this section.

(iii) Effect of nonconforming elections. An attempted election that does not satisfy the requirements of this paragraph (c)(3) (including an attempted election made on a return for a taxable year prior to the election year) is not valid.

(4) Amended return requirements -- (i) Requirements. A taxpayer subject to this paragraph (c)(4) must amend all previously filed income tax returns as necessary to

conform the taxpayer's treatment of transition period property to the treatment required under the intangibles provisions of OBRA '93. See paragraph (c)(5) of this section for certain adjustments that may be required on the amended returns required under this paragraph (c)(4) in the case of certain consolidated group member dispositions and tax-free transactions.

(ii) Applicability. This paragraph (c)(4) applies to a taxpayer if --

(A) The taxpayer makes the retroactive election; or

(B) Another person's retroactive election applies to the taxpayer or to any property acquired by the taxpayer.

(5) Adjustment required with respect to certain consolidated group member dispositions and tax-free transactions -- (i) Application. This paragraph (c)(5) applies to transition period property if the intangibles provisions of OBRA '93 first apply to the property while it is held by the taxpayer but do not apply to the property for some period (the "interim period") after the property is acquired (or considered acquired) by the taxpayer. For example, this paragraph (c)(5) may apply to transition period property held by a former member of a consolidated group if a retroactive election is made by or on behalf of the former member but is not made by the consolidated group. See paragraph (c)(1)(v) of this section.

(ii) Required adjustment to income. If this paragraph (c)(5) applies, an adjustment must be taken into account in computing taxable income of the taxpayer for the taxable year in which the intangibles provisions of OBRA '93 first apply to the property. The amount of the adjustment is equal to the difference for the transition period property between --

(A) The sum of the depreciation, amortization, or other cost recovery deductions that the taxpayer (and its predecessors) would have been permitted if the intangibles provisions of OBRA '93 applied to the property during the interim period; and

(B) The sum of the depreciation, amortization, or other cost recovery deductions that the taxpayer (and its predecessors) claimed during that interim period.

(iii) Required adjustment to basis. The taxpayer also must make a corresponding adjustment to the basis of its transition period property to reflect any adjustment to taxable income with respect to the property under this paragraph (c)(5).

(6) Notification requirements -- (i) Notification of commonly controlled taxpayers. A taxpayer that makes the retroactive election must provide written notification of the retroactive election (on or before the election date) to each taxpayer that is under common control with the electing taxpayer.

(ii) Notification of certain former members, former consolidated groups, and transferees. This paragraph (c)(6)(ii) applies to a common parent of a consolidated group that makes or is notified of a retroactive election that applies to transition period property of a former member, a corporation that makes or is notified of a retroactive election that affects any consolidated group of which the corporation is a former member, or a taxpayer that makes or is notified of a retroactive election that applies to transition period property the taxpayer transfers in a transaction described in paragraph (c)(1)(iv)(C) of this section. Such common parent, former member, or transferor must provide written notification of the retroactive election to any affected former member, consolidated group, or transferee. The written notification must be provided on or before the election date in the case of an election by the common parent, former member, or transferor, and within 30 days of the election date in the case of an election by a person other than the common parent, former member, or transferor.

(7) Revocation. Once made, the retroactive election may be revoked only with the consent of the Commissioner.

(8) Examples. The following examples illustrate the application of this paragraph (c).

Example 1. (i) X is a partnership with 5 equal partners, A through E. X acquires in 1989, as its sole asset, intangible asset M. X has a section 754 election in effect for all relevant years. F, an unrelated individual, purchases A's entire interest in the X partnership in January 1993 for $ 700. At the time of F's purchase, X's inside basis for M is $ 2,000, and its fair market value is $ 3,500.

(ii) Under section 743(b), X makes an adjustment to increase F's basis in asset M by $ 300, the difference between the allocated purchase price and M's inside basis ($ 700 - $ 400 = $ 300). Under paragraphs (b)(8) and (c)(2)(ii) of this section, if F makes the retroactive election, the section 743(b) basis increase of $ 300 in M is an amortizable section 197 intangible even though asset M is not an amortizable section 197 intangible in the hands of X. F's increase in the basis of asset M is amortizable over 15 years beginning with the month of F's acquisition of the partnership interest. With respect to the remaining $ 400 of basis, F is treated as stepping into A's shoes and continues A's amortization (if any) in asset M. F's retroactive election applies to all other intangibles acquired by F or a taxpayer under common control with F.

Example 2. A, a calendar year taxpayer, is under common control with B, a June 30 fiscal year taxpayer. A files its original election year Federal income tax return on March 15, 1994, and does not make either the retroactive election or the binding contract election. B files its election year tax return on September 15, 1994, and makes the retroactive election. B is required by paragraph (c)(6)(i) of this section to notify A of its election. Even though A had already filed its election year return, A is bound by B's retroactive election under the common control rules. Additionally, if A had made a binding contract election, it would have been negated by B's retroactive election. Because of B's retroactive election, A must comply with the requirements of this paragraph (c), and

file amended returns for the election year and any affected prior years as necessary to conform the treatment of transition period property to the treatment required under the intangibles provisions of OBRA '93.

Example 3. (i) P and Y, calendar year taxpayers, are the common parents of unrelated calendar year consolidated groups. On August 15, 1991, S, a subsidiary member of the P group, acquires a section 197 intangible with an unadjusted basis of $ 180. Under prior law, no amortization or depreciation was allowed with respect to the acquired intangible. On November 1, 1992, a member of the Y group acquires the S stock in a taxable transaction. On the P group's 1993 consolidated return, P makes the retroactive election. The P group also files amended returns for its affected prior years. Y does not make the retroactive election for the Y group.

(ii) Under paragraph (c)(1)(iii) of this section, a retroactive election by the common parent of a consolidated group applies to all transition period property acquired by a former member while it was a member of the group. The section 197 intangible acquired by S is transition period property that S, a former member of the P group, acquired while a member of the P group. Thus, P's election applies to the acquired asset. P must notify S of the election pursuant to paragraph (c)(6)(ii) of this section.

(iii) S amortizes the unadjusted basis of its eligible section 197 intangible ($ 180) over the 15-year amortization period using the applicable convention beginning as of the first day of the month of acquisition (August 1, 1991). Thus, the P group amends its 1991 consolidated tax return to take into account $ 5 of amortization ($ 180/15 years x 5/12 year = $ 5) for S.

(iv) For 1992, S is entitled to $ 12 of amortization ($ 180/15). Assume that under § 1.1502-76, $ 10 of S's amortization for 1992 is allocated to the P group's consolidated return and $ 2 is allocated to the Y group's return. The P group amends its 1992 consolidated tax return to reflect the $ 10 deduction for S. The Y group must amend its 1992 return to reflect the $ 2 deduction for S.

Example 4. (i) The facts are the same as in Example 3, except that the retroactive election is made for the Y group, not for the P group.

(ii) The Y group amends its 1992 consolidated return to claim a section 197 deduction of $ 2 ($ 180/15 years x 2/12 year = $ 2) for S.

(iii) Under paragraph (c)(1)(ii) of this section, the retroactive election by Y applies to all transition period property acquired by S. However, under paragraph (c)(1)(v)(A) of this section, the intangibles provisions of OBRA '93 do not apply to S's transition period property during the period when it held such property as a member of P group. Instead, these provisions become applicable to S's transition period property beginning on November 1, 1992, when S becomes a member of Y group.

(iv) Because the P group did not make the retroactive election, there is an interim period during which the intangibles provisions of OBRA '93 do not apply to the asset acquired by S. Thus, under paragraph (c)(5) of this section, the Y group must take into account in computing taxable income in 1992 an adjustment equal to the difference between the section 197 deduction that would have been permitted if the intangibles provisions of OBRA '93 applied to the property for the interim period (i.e., the period for which S was included in the P group's 1991 and 1992 consolidated returns) and any amortization or depreciation deductions claimed by S for the transferred intangible for that period. The retroactive election does not affect the P group, and the P group is not required to amend its returns.

Example 5. The facts are the same as in Example 3, except that both P and Y make the retroactive election. P must notify S of its election pursuant to paragraph (c)(6)(ii) of this section. Further, both the P and Y groups must file amended returns for affected prior years. Because there is no period of time during which the intangibles provisions of OBRA '93 do not apply to the asset acquired by S, the Y group is permitted no adjustment under paragraph (c)(5) of this section for the asset.

(d) Binding contract election -- (1) General rule -- (i) Effect of election. If a taxpayer acquires property pursuant to a written binding contract in effect on August 10, 1993, and at all times thereafter before the acquisition (an eligible acquisition) and makes the binding contract election with respect to the contract, the law in effect prior to the enactment of OBRA '93 will apply to all property acquired pursuant to the contract. A separate binding contract election must be made with respect to each eligible acquisition to which the law in effect prior to the enactment of OBRA '93 is to apply.

(ii) Taxpayers subject to retroactive election. A taxpayer may not make the binding contract election if the taxpayer or a person under common control with the taxpayer makes the retroactive election under paragraph (c) of this section.

(iii) Revocation. A binding contract election, once made, may be revoked only with the consent of the Commissioner.

(2) Time and manner of election -- (i) Time. In general, the binding contract election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the election year. If, however, the taxpayer's original Federal income tax return for the election year is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994.

(ii) Manner. The binding contract election is made by attaching the election statement described in paragraph (e) of this section to the taxpayer's original or amended income tax return for the election year.

(iii) Effect of nonconforming election. An attempted election that does not satisfy the requirements of this paragraph (d)(2) is not valid.

(e) Election statement -- (1) Filing requirements. For an election under paragraph (c) or (d) of this section to be valid, the electing taxpayer must:

(i) File (with its Federal income tax return for the election year and with any affected amended returns required under paragraph (c)(4) of this section) a written election statement, as an attachment to Form 4562 (Depreciation and Amortization), that satisfies the requirements of paragraph (e)(2) of this section; and

(ii) Forward a copy of the election statement to the Statistics Branch (QAMIRS Ogden Service Center, ATTN: Chief, Statistics Branch, P.O. Box 9941, Ogden, UT 84409.

(2) Content of the election statement. The written election statement must include the information in paragraphs (e)(2) (i) through (vi) and (ix) of this section in the case of a retroactive election, and the information in paragraphs (e)(2) (i) and (vii) through (ix) of this section in the case of a binding contract election. The required information should be arranged and identified in accordance with the following order and numbering system --

(i) The name, address and taxpayer identification number (TIN) of the electing taxpayer (and the common parent if a consolidated return is filed).

(ii) A statement that the taxpayer is making the retroactive election.

(iii) Identification of the transition period property affected by the retroactive election, the name and TIN of the person from which the property was acquired, the manner and date of acquisition, the basis at which the property was acquired, and the amount of depreciation, amortization, or other cost recovery under section 167 or any other provision of the Code claimed with respect to the property.

(iv) Identification of each taxpayer under common control (as defined in paragraph (b)(6) of this section) with the electing taxpayer by name, TIN, and Internal Revenue Service Center where the taxpayer's income tax return is filed.

(v) If any persons are required to be notified of the retroactive election under paragraph (c)(6) of this section, identification of such persons and certification that written notification of the election has been provided to such persons.

(vi) A statement that the transition period property being amortized under section 197 is not subject to the anti-churning rules of section 197(f)(9).

(vii) A statement that the taxpayer is making the binding contract election.

(viii) Identification of the property affected by the binding contract election, the name and TIN of the person from which the property was acquired, the manner and date of

acquisition, the basis at which the property was acquired, and whether any of the property is subject to depreciation under section 167 or to amortization or other cost recovery under any other provision of the Code.

(ix) The signature of the taxpayer or an individual authorized to sign the taxpayer's Federal income tax return.

(f) Effective date. These regulations are effective March 15, 1994.

[EFFECTIVE DATE NOTE: T.D. 8528, 59 FR 11922, Mar. 15, 1994, which added this section, became effective Mar. 15, 1994.]

HISTORY: [T.D. 8528, 59 FR 11922, Mar. 15, 1994]

AUTHORITY: AUTHORITY NOTE APPLICABLE TO ENTIRE PART: 26 U.S.C. 7805.

NOTES: Section 1.197-1T also issued under 26 U.S.C. 197(g).

NOTES APPLICABLE TO ENTIRE CHAPTER: EDITORIAL NOTES: (1) IRS published a document at 45 FR 6088, Jan. 25, 1980, deleting statutory sections from their regulations. In Chpater I, cross references to the deleted material have been changed to the corresponding sections of the IRS Code of 1954 or to the appropriate regulations sections. When either such change produced a redundancy, the cross reference has been deleted. For further explanation, see 45 FR 20795, March 31, 1980. [(2) The OMB control numbers for title 26 appear in §§ 601.9000 and 602.101 of this chapter.]

NOTES APPLICABLE TO ENTIRE SUBCHAPTER: Supplementary Publications: Internal Revenue Service Looseleaf Regulations System, Alcohol and Tobacco Tax Regulations, and Regulations Under Tax Conventions. EDITORIAL NOTE: Treasury Decision 6091, 19 FR 5167, Aug. 17, 1954, provides in part as follows: PARAGRAPH 1. All regulations (including all Treasury decisions) prescribed by, or under authority duly delegated by, the Secretary of the Treasury, or jointly by the Secretary and the Commissioner of Internal Revenue, or by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, or jointly by the Commissioner of Internal Revenue and the Commissioner of Customs or the Commissioner of Narcotics with the approval of the Secretary of the Treasury, applicable under any provision of law in effect on the date of enactment of the Code, to the extent such provision of law is repealed by the Code, are hereby prescribed under and made applicable to the provisions of the Code corresponding to the provision of law so repealed insofar as any such regulation is not inconsistent with the Code. Such regulations shall become effective as regulations under the various provisions of the Code as of the dates the corresponding provisions of law are repealed by the Code, until superseded by regulations issued under the Code. PAR. 2. With respect to any provision of the Code which depends for its application upon the promulgation of regulations or which is to be applied in such manner as may be prescribed by regulations, all instructions or rules in effect

immediately prior to the enactment of the Code, to the extent such instructions or rules could be prescribed as regulations under authority of such provision of the Code, shall be applied as regulations under such provision insofar as such instructions or rules are not inconsistent with the Code. Such instructions or rules shall be applied as regulations under the applicable provision of the Code as of the date such provision takes effect. PAR. 3. If any election made or other act done pursuant to any provision of the Internal Revenue Code of 1939 or prior internal revenue laws would (except for the enactment of the Code) be effective for any period subsequent to such enactment, and if corresponding provisions are contained in the Code, such election or other act shall be given the same effect under the corresponding provisions of the Code to the extent not inconsistent therewith. The term "act" includes, but is not limited to, an allocation, identification, declaration, agreemtent, option, waiver, relinquishment, or renunciation. PAR. 4. The limits of the various internal revenue districts have not been changed by the enactment of the Code. Furthermore, delegations of authority made pursuant to the provisions of Reorganization Plan No. 26 of 1950 and Reorganization Plan No. 1 of 1952 (as well as redelegation thereunder), including those governing the authority of the Commissioner of Internal Revenue, the Regional Commissioners of Internal Revenue, or the District Directors of Internal Revenue, are applicable to the provisions of the Code to the extent consistent therewith.

APPENDIX C

ITHACA INDUSTRIES, INC., Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.

No. 92-1045

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

17 F.3d 684; 1994 U.S. App. LEXIS 3136;
94-1 U.S. Tax Cas. (CCH) P50,100; 73 A.F.T.R.2d (P-H) 1323

October 27, 1993, Argued

February 23, 1994, Decided

SUBSEQUENT HISTORY: [**1] Certiorari Denied October 3, 1994, Reported at: 1994 U.S. LEXIS 5593.

PRIOR HISTORY: Appeal from the United States Tax Court. (Tax Ct. No. 89-7076)

DISPOSITION: AFFIRMED

COUNSEL: Argued: Charles T. Zink, LONG, ALDRIDGE & NORMAN, Atlanta, Georgia, for Appellant.

Argued: Jonathan Samuel Cohen, Tax Division, UNITED STATES DEPARTMENT OF JUSTICE, Washington, D.C., for Appellee.

On Brief: Patrick G. Jones, David M. Ivey, Phillip A. Bradley, Kendall L. Houghton, LONG, ALDRIDGE & NORMAN, Atlanta, Georgia, for Appellant.

On Brief: Michael L. Paup, Acting Assistant Attorney General, Gary R. Allen, Ernest J. Brown, Tax Division, UNITED STATES DEPARTMENT OF JUSTICE, Washington, D.C., for Appellee.

JUDGES: Before PHILLIPS and WILKINSON, Circuit Judges, and MICHAEL, United States District Judge for the Western District of Virginia, sitting by designation. Judge Michael wrote the opinion, in which Judge Wilkinson concurred. Judge Phillips wrote an opinion concurring in part and dissenting in part.

OPINION BY: MICHAEL

OPINION: [*686] OPINION

MICHAEL, District Judge:

Ithaca Industries, Inc. (Ithaca) appeals from the decision of the Tax Court denying depreciation deductions for Ithaca's assembled workforce and assessing Ithaca for tax deficiencies as a result. Because we believe that the useful life of an assembled workforce such [**2] as Ithaca's has no reasonably ascertainable limits, we affirm.

I.

At all relevant times for the purposes of this case, Ithaca was a Delaware corporation with its headquarters in Wilkesboro, North Carolina. The company manufactures hosiery, undergarments, and polo shirts in plants located in North and South Carolina, Georgia, and Arizona. On September 22, 1983, some 35 years after Ithaca was first founded, a corporation was formed for the purpose of acquiring the assets and business of the company. That corporation, called "New Ithaca Corporation," subsequently offered "Old Ithaca" $ 110 million in notes and cash in exchange for all of Old Ithaca's common stock. The purpose of the merger was primarily to provide liquidity to George Abbot, the company's retiring founder and majority stockholder.

After the transaction was completed on October 28, 1983, New Ithaca changed its name to Ithaca Industries, Inc., the appellant in this case. There were no negotiations with Old Ithaca prior to this date regarding the allocation of portions of the purchase price to the assets New Ithaca was to acquire. Prior to the merger, however, New Ithaca obtained an appraisal of Old Ithaca's assets, [**3] to be used to determine an allocation of basis for tax purposes. One such asset was Old Ithaca's assembled workforce of 5,153 hourly production workers and 212 staff employees. n1 The appraiser assigned this "workforce in place" a value of $ 7.7 million, with a useful life of seven years for production employees, and eight years for staff employees.

----------Footnotes----------

n1 Also at issue below were certain raw materials supply contracts upon which Ithaca took depreciation deductions. Respondent did not take exception to the Tax Court's holding regarding the contracts.

----------End Footnotes----------

Based on the appraisal, Ithaca took depreciation deductions in the fiscal years ending February, 1984 and February, 1985. When appellee, Commissioner of the Internal Revenue Service (Commissioner) disallowed the deductions, Ithaca petitioned the Tax Court in April, 1989. The Tax Court found for the Commissioner on the workforce issue,

holding that a workforce is non-depreciable because it is not a "wasting asset." Ithaca Industries, Inc. v. Comm'r, 97 T.C. 253 (1991). [**4] This appeal followed.

The central issue on appeal is whether an assembled workforce is an intangible asset having an ascertainable, limited useful life over which the value of the asset may be amortized. The Commissioner raised a second potential issue for the first time on appeal. n2 The Commissioner suggests that the applicable provisions of the Internal Revenue Code as of Ithaca's merger required it to make a specific election in order to obtain a "stepped-up" basis in the assets it acquired. Absent such an election, appellee submits, the basis in the acquired assets -- including the assembled workforce -- is a "carryover" basis of zero. n3 Without a basis, there obviously [*687] can be no depreciation, and the Commissioner asks us to affirm on those grounds. n4 We decline to pass on the merits of this question, however, principally because its development before us, and before the Tax Court, was incomplete. We therefore will resolve the case by deciding the appropriate tax treatment of an assembled workforce with a stepped-up basis in the surviving corporation's hands.

----------Footnotes----------

n2 As the Commissioner points out in his brief, respondent is free to rely upon any matter appearing in the record in support of the decision below without filing a cross-appeal. See Schweiker v. Hogan, 457 U.S. 569, 585 n. 24, 73 L. Ed. 2d 227, 102 S. Ct. 2597 (1982). [**5]

n3 The carryover basis would be zero because Old Ithaca's assets were fully depreciated in its hands.

n4 The Commissioner recognizes that his failure to appeal that portion of the Tax Court's decision allowing deductions for the raw materials supply contracts precludes him from making this argument with regard to those particular assets.

----------End Footnotes----------

II.

We begin with the prosaic observation that every asset declines in some manner, and thus, in theory, every asset could be amortized. This observation is set forth more or less in Section 167(a) of the Internal Revenue Code. At the time of Ithaca's merger, that section stated: "There shall be as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . of property used in the trade or business, or . . . of property held for the production of income." n5 I.R.C. § 167(a) (1983). Things become a good deal more complicated, however, when we seek in practical terms to quantify "exhaustion" and "wear and tear" for the purpose of assigning depreciation deductions to specific assets. To do so, Congress has often had to resort [**6] to conventions. n6

----------Footnotes----------

n5 The term "property" includes intangibles. Citizens & Southern Corp. v. Commissioner, 91 T.C. 463 (1988), aff'd, 900 F.2d 266 (11th Cir. 1990).

n6 Section 168 of the Internal Revenue Code sets forth a variety of amortization schedules which assign recovery periods for various categories of depreciable assets. A new section 197 was added to the I.R.C. on August 10, 1993, which assigns a 15-year recovery period for intangible assets enumerated in that section. Had this section existed in 1983, this case would be less difficult in one respect, for section 197(d)(1)(C)(i) includes "workforce in place" as an intangible asset subject to depreciation over 15 years, a period roughly twice as long as the period Ithaca claimed. Of course, the difficulty of assigning an initial value to such a workforce still would remain.

----------End Footnotes----------

Courts too have adopted conventions, n7 one of which has been the categorical exclusion of "goodwill" and "going-concern [**7] value" from the purview of section 167. See Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129, 38 L. Ed. 2d 754, 94 S. Ct. 867 (1974). "While goodwill and going-concern value are often referred to conjunctively, technically going-concern value is the ability of a business to generate income without interruption, even though there has been a change in ownership; and goodwill is a 'preexisting' business relationship, based on a continuous course of dealing, which may be expected to continue indefinitely." Ithaca Industries, 97 T.C. 253 (slip op. at 17-18). These are elements of value which have always been understood to be non-depreciable, primarily because they do not decline in any readily ascertainable fashion, but also because their initial value is difficult to appraise.

----------Footnotes----------

n7 In fact, the Treasury Regulations appear to envision an evolving case law on the question of depreciability. Section 1.167(a)-3 of those Regulations provides that a depreciation deduction may be taken only when an 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 . . . ." 26 C.F.R. § 1.167(a)-3 (1993) (emphasis supplied).

----------End Footnotes---------- [**8]

One of the reasons the Tax Court felt that Ithaca's workforce was non-depreciable was because the workforce closely resembled going-concern value. Indeed, "the existence of a trained and operational staff allowed Ithaca to step into the shoes of Old Ithaca." Id. This approach, measuring the asset against the definition of going concern value, was supported by then-existing law, see Houston Chronicle, 481 F.2d 1240, but has

been modified by the Supreme Court's recent holding in Newark Morning Ledger Co. v. United States, 123 L. Ed. 2d 288, 113 S. Ct. 1670 (1993). That case addressed only goodwill specifically, but its teaching is equally applicable to going-concern value. The Court stated, "we now hold 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 [*688] over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage. . . ." 113 S. Ct. at 1681 (emphasis supplied). Thus, it is no longer appropriate to classify an intangible asset based on its resemblance to the classic conception of goodwill [**9] or going-concern value, and Ithaca's deduction cannot be denied on that basis.

Newark Morning Ledger does not, however, wholly eliminate a categorical approach to the question whether an asset declines, or "wastes," within the meaning of section 167. The Court left intact the so-called "mass asset" rule, which provides that certain kinds of intangible assets are properly grouped and considered as a single entity; even though the individual components of the asset may expire or terminate over time, they are replaced by new components, thereby causing only minimal fluctuations and no measurable loss in the value of the whole. Id. at 1676. n8 A mass asset is thought to be non-wasting, and therefore not depreciable, because it is continually regenerated, such that at any given time, the asset is the same in all material respects as it always has been. This is so even when the asset's constitutive elements change over time.

----------Footnotes----------

n8 We emphasize, however, that the potential application of the mass asset rule in this case has nothing to do with whether the workforce appears to contribute to going concern value. The Supreme Court has indicated that after Houston Chronicle, the rule could no longer serve as authority for classing all assets "related to the expectancy of continued patronage" as inseparable components of the single non-depreciable asset of goodwill. Newark Morning Ledger, 113 S. Ct. at 1677. The reasoning of Houston Chronicle would also prohibit application of the mass asset rule to defeat amortization of all assets contributing to the expectancy of uninterrupted business, that is, to going concern value. Thus, along with the classic conception of goodwill and going concern value, Newark Morning Ledger subsumes the mass asset rule under a broader inquiry aimed at determining whether the asset can be valued and whether its useful life is limited. See infra, note 11 and accompanying text.

----------End Footnotes---------- [**10]

On its face, then, a workforce that remains constant in size and function over the years would appear to be a quintessential mass asset. As employees leave the workforce, new individuals are hired to assume the responsibilities of each vacant position. These new employees are indeed distinct from the individuals who made up the original workforce, but for all practical purposes the assembled workforce as a whole is preserved.

As the Court suggested in Newark Morning Ledger, however, the distinguishing feature of a true mass asset is its ability to be regenerated without substantial effort on the part of its owner, that is, its ability to "self-regenerate." n9 When an asset is maintained only by significant affirmative efforts to add new elements, these additions are most naturally understood as comprising something new and distinct from the original asset. Conceptually, the "old" asset continues to decline, even as the owner acquires new elements to offset declining productivity in the combination of elements that is the old asset. Though the line of demarcation is subtle, this situation is analytically distinct from one in which the asset is replenished without significant [**11] effort; such a "self-regenerating" asset requires little or no active addition of new elements to preserve it against decline. Thus, when an intangible asset such as a workforce is maintained only by obtaining costly replacements, those replacements do not prevent decline in the existing asset so much as they contribute to what might be considered a new one. In [*689] such a case, the "mass asset rule" would not defeat amortization of the asset.

----------Footnotes----------

n9 The Court's discussion of the District Court's opinion in Newark Morning Ledger illustrates the importance of the concept of self-regeneration to the mass asset rule:

Petitioner also proved to the satisfaction of the District Court that its "paid subscriber" asset [a list of subscribers obtained by one newspaper in its takeover of another] was not self-regenerating, thereby distinguishing it for purposes of applying the mass-asset rule:

"There is no automatic replacement for a subscriber who terminates his or her subscription. Although the total number of subscribers may have or has remained relatively constant, . . . those that may or have discontinued their subscriptions can be or have been replaced only through the substantial efforts of [the newspaper]."

Newark Morning Ledger, 113 S. Ct. at 1681 (emphasis supplied) (citation omitted).

----------End Footnotes----------[**12]

The distinction is crucial in this case, for Ithaca's workforce as a whole was indeed regenerated each time a new worker was brought in to fill a vacancy, such that the size and function of the workforce remained essentially the same. This regeneration, however, was accomplished only through Ithaca's substantial efforts. Absent those efforts, the workforce as it was constituted on the date of the merger would have declined until there were no employees left in it. Ithaca did not have replacement workers standing ready to be hired and put to work without significant preparation. On the contrary, the record indicates that Ithaca had to train its workers extensively, and in some cases even had to recruit them. n10 In fact, it is these expenses which form the basis of the

value Ithaca has assigned to the workforce. Under these circumstances, the mass-asset rule does not deny Ithaca a depreciation deduction for its workforce.

----------Footnotes----------

n10 Ithaca's recruiting and training expenses may well have been deductible, but the tax treatment of these expenses is irrelevant to the issue of self-regeneration and the application of the mass asset rule. Cf. Computing & Software, Inc. v. Comm'r, 64 T.C. 223, 236-37 (1975) (original body of credit information amortizable despite continual replacement with new information by clerks whose pay was currently deductible). After all, even if a traditionally depreciable, tangible business asset like a truck could be preserved indefinitely with new parts and the labor required to install them, we would not think that the truck was self-regenerating and non-wasting simply because the expenses of this maintenance were deductible. The important question is whether the asset's maintenance is accomplished by significant efforts not already expended in the initial formation or purchase of the asset.

----------End Footnotes---------- [**13]

The inquiry must therefore turn to whether Ithaca's workforce has an ascertainable value and a limited useful life. n11 Because the Tax Court did not feel that a regenerating asset such as a workforce could waste, it did not undertake to assess Ithaca's statistical evidence on these questions in any detail. We need not pay detailed attention to Ithaca's statistical methodology, either, but we look beyond this evidence for a different reason. We do not doubt that Ithaca's workforce, as constituted on the day of the merger, began to decline in size and value with the first resignation, termination, or death in that workforce, and that it continued to decline due to these and other factors. Nor do we take issue at this time with the value Ithaca placed on that workforce. n12 The difficulty in our view is that under these circumstances there can be no defensible estimation of the duration of any one person's employment, nor of the useful life of the workforce of which he or she is a part.

----------Footnotes----------

n11 Of course, this broader inquiry addresses many of the same issues with which the mass asset rule is concerned. As the Fifth Circuit noted in Houston Chronicle, "most of the cases purporting to apply the 'mass asset' rule involve evidentiary failures on the part of the taxpayer[,]" namely, a failure to show that the asset has an ascertainable value and a limited useful life. 481 F.2d at 1249-50. Stated another way, if the taxpayer is unable to counter the inference that his asset self-regenerates, and is therefore a mass asset, he has also failed to prove that the useful life of his asset is limited. [**14]

n12 We must note, however, our concern with Ithaca's use of the cost of recruiting and training replacement workers as a proxy for the value of the workforce obtained

from Old Ithaca. The two groups of workers may not be sufficiently comparable to allow this approach. Cf. Newark Morning Ledger, 113 S. Ct. at 1682 (citing district court's finding that new newspaper subscribers were not comparable in value to customers on existing subscriber list).

----------End Footnotes----------

In Newark Morning Ledger, the taxpayer was a newspaper which sought to amortize the body of subscriptions it obtained from another newspaper in a merger. Despite the fact that new subscriptions were coming in daily to replace lapsed ones, the Court allowed Newark Morning Ledger to depreciate the old subscription list. It did so, however, only because the body of subscriptions as it was constituted on the merger date "was not composed of constantly fluctuating components; rather, it consisted of identifiable subscriptions each of which had a limited useful life that could be estimated with reasonable accuracy according [**15] to generally accepted statistical principles." Newark Morning Ledger, 113 S. Ct. at 1681. Though each subscription was terminable at will by the subscriber, there were some 460,000 paid subscribers on the list Newark [*690] Morning Ledger obtained. The large sample size enabled the newspaper's experts to employ historical and demographic data on mortality and relocation rates, as well as changing tastes and media competition, to arrive at an estimate of useful life. n13

----------Footnotes----------

n13 The Government contested none of this evidence, but chose instead to stand on the assertion that "paid subscribers" are indistinguishable from the concept of goodwill. The adequacy of Newark Morning Ledger's evidence thus was not directly before the Court.

----------End Footnotes----------

Without intimating a view whether Newark Morning News' method would produce an adequate estimate, we can say that this case presents a rather different set of circumstances. An employee is not a subscription; indeed, a workforce consisting of human beings perhaps [**16] could be no better described than as "composed of constantly fluctuating components." We note in this regard that the record discloses no predetermined limits of any sort, contractual or otherwise, upon the relationship between Ithaca and its employees. This means that in contrast to a subscription, which is susceptible mainly to the influences affecting one actor, the subscriber, a single employment relationship is susceptible to changing influences affecting two actors, the employer and the employee.

We are not persuaded that Ithaca can control for these influences. With a large enough sample size and a test period of sufficient length, it is conceivable that pertinent variables and reliable patterns of attrition could be identified. This, after all, is the purported accomplishment of actuarial compilations used in the insurance industry. And

theoretically, similar data might be derived from very small, exceptionally stable environments. But we are far from being able to perform such feats reliably with a sample size of roughly 5,000 different people, over only a four-year period, and with only four classifications by job type. n14

----------Footnotes----------

n14 Ithaca's statistical expert, Dr. Doerfler, analyzed Old Ithaca's employment experience from 1979 until the merger date, assessing the average useful lives for workers in four categories: hourly and production workers, executives, salaried employees, and clerical employees.

----------End Footnotes----------[**17]

Ithaca's representation that its estimate of attrition rate was borne out following the merger does not convince us otherwise. An unforeseen change in any pertinent variable might have radically undermined Ithaca's estimate at any time, and the fact that it did not is in this court's judgment little more than happenstance. The revenue consequences are simply too serious to tolerate this level of imprecision, and we cannot now envision an approach to a workforce such as Ithaca's that would not suffer from the same shortcomings as Ithaca's statistical method. n15

----------Footnotes----------

n15 We are mindful, of course, that in Citizens & Southern Corp. v. Comm'r, 91 T.C. 463 (1988), aff'd, 919 F.2d 1492 (11th Cir. 1990) (per curiam), the Tax Court approved Dr. Doerfler's useful life analysis, a methodology similar to the one employed here. Citizens & Southern, however, dealt with the depreciability of a bank's deposit base. We believe, as we have indicated, that a workforce such as Ithaca's poses a far greater challenge. A workforce is an unusual asset because it is not only affected by human decisionmaking, but is actually composed of multiple human actors. As such, it is directly affected by the complex interactions of its employees, and by any number of other influences operating upon these actors both in and out of the workplace. This substantial human element injects vagaries into the useful life analysis that make inapt, on the facts of this case, the analysis used in Citizens & Southern.

----------End Footnotes----------[**18]

In sum, we hold that Ithaca's workforce was not an amortizable asset because its characteristics suggest no sufficiently accurate means of estimating its useful life. In the absence of a firmer foundation, we must also decline to choose an appropriate useful life convention. If any conventions are to be adopted to end the intractable struggles over the depreciability of intangible assets such as this, it is the province of Congress to do so. n16 The opinion of the Tax Court is therefore

AFFIRMED.

----------Footnotes----------

n16 In this vein, Congress adopted section 197 of the Internal Revenue Code in August, 1993. See supra, note 6. The avowed purpose of section 197 was to eliminate "the considerable controversy" that has existed between taxpayers and the Internal Revenue Service over whether and how to amortize intangible assets, a controversy which Congress predicted would continue even after Newark Morning Ledger. See H.R. Rep. No. 103-11, 103rd Cong., 1st Sess. 760 (1993). As counsel for the Commissioner stated at oral argument, however, the new section is merely a convention, meant only to bring "peace."

----------End Footnotes---------- [**19]

CONCUR BY: PHILLIPS (In Part)

DISSENT BY: PHILLIPS (In Part)

DISSENT: PHILLIPS, Circuit Judge, concurring in part and dissenting in part:

[*691] I agree completely with Judge Michael's excellent legal analysis leading to the conclusions that (1) Ithaca Industries' claimed deduction is not defeated by the mass asset rule, and (2) could only be defeated by a determination that its workforce either had no ascertainable value upon acquisition or no ascertainable limited life thereafter. I disagree however, with the further conclusion that we should decide as a matter of law on this appeal that it had neither.

Those issues should, I believe, be remanded for first instance determination by the Tax Court where they were raised but not decided. I think we jump the gun in deciding (as I read the majority opinion) that as a matter of law no statistical methodology (not just that of Ithaca Industries' original proffer) could provide a sufficiently trustworthy evidentiary basis for finding both ascertainable value and limited useful life for this work force. See slip op. 8-11. I believe instead that the Tax Court as trier-of-fact should originally make that assessment. It might well decide, after carefully considering [**20] the proffered evidence, that it had just the inherent incapacity the majority assigns it. But it might in the context of an appropriate evidentiary hearing find a sufficiency of strength that we are not in too good a position to assess without benefit of any first-instance effort by the base-line trier-of-fact.

For that reason, I would remand those issues for determination by the Tax Court.

APPENDIX D

NEWARK MORNING LEDGER CO., AS SUCCESSOR TO THE HERALD COMPANY, PETITIONER
v.
UNITED STATES

NEWARK MORNING LEDGER CO.
v.
UNITED STATES

No. 91-1135

SUPREME COURT OF THE UNITED STATES

113 S. Ct. 1670; 1993 U.S. LEXIS 2979; 123 L. Ed. 2d 288;
61U.S.L.W. 4313; 26 U.S.P.Q.2D (BNA) 1427;
93-1 U.S. Tax Cas. (CCH) P50,228; 71 A.F.T.R.2d (P-H) 1380;
21 Media L. Rep. 1289; 93 Cal. Daily Op. Service 2838;
93 Daily Journal DAR 4903; 7 Fla. Law W. Fed. S 151

November 10, 1992, Argued

April 20, 1993, Decided

NOTICE: [*1] The LEXIS pagination of this document is subject to change pending release of the final published version.

PRIOR HISTORY: ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

DISPOSITION: 945 F.2d 555, reversed and remanded.

SYLLABUS: Petitioner newspaper publisher is the successor to The Herald Company. When, in 1976, Herald purchased substantially all the outstanding shares of Booth Newspapers, Inc., it allocated its adjusted income tax basis in the Booth shares among the assets it acquired in its merger with Booth. Among other things, it allocated $ 67.8 million to an intangible asset denominated "paid subscribers," a figure that was petitioner's estimate of future profits to be derived from identified subscribers to Booth's eight newspapers on the date of merger. On its federal income tax returns for 1977-1980, Herald claimed depreciation deductions for the $ 67.8 million, which were disallowed by the Internal Revenue Service (IRS) on the ground that the [*2] concept of "paid subscribers" was indistinguishable from goodwill and, therefore, was nondepreciable. Herald paid the taxes, and petitioner filed refund claims and ultimately brought suit in the District Court to recover taxes and interest paid. At trial, the Government did

not contest petitioner's expert evidence on the methodology used to calculate its figure and stipulated to the useful life of "paid subscribers" for each newspaper. Instead, it estimated the asset's value at $ 3 million, the cost of generating new subscriptions, and its principal argument remained that the asset was indistinguishable from goodwill. The court ruled in petitioner's favor, finding that the asset was not self-regenerating -- i.e., it had a limited useful life, the duration of which could be calculated with reasonable accuracy -- that petitioner properly calculated its value, and that it was separate and distinct from goodwill. The Court of Appeals reversed, holding that even though the asset may have a limited useful life that can be ascertained with reasonable accuracy, its value is not separate and distinct from goodwill.

Held:

1. A taxpayer able to prove that a particular asset can [*3] 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. Pp. 6-19.

(a) While the depreciation allowance of § 167(a) of the Internal Revenue Code applies to intangible assets, the IRS has consistently taken the position that goodwill is non-depreciable. Since the value of customer-based intangibles, such as customer and subscriber lists, obviously depends on continued and voluntary customer patronage, the question has been whether these intangibles can be depreciated notwithstanding their relationship to such patronage. The "mass asset" rule that courts often resort to in considering this question prohibits depreciation when the assets constitute self-regenerating assets that may change but never waste. Pp. 6-13.

(b) Whether or not taxpayers have been successful in separating depreciable intangible assets from goodwill in any particular case is a question of fact. The question is not whether an asset falls within the core of the concept of goodwill, but whether it is capable of being valued and whether that value diminishes over time. Pp. 13-19.

2. Petitioner [*4] has borne successfully its substantial burden of proving that "paid subscribers" constitutes an intangible asset with an ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy. It has proved that the asset is not self-regenerating but rather wastes as a finite number of component subscriptions are canceled over a reasonably predictable period of time. The Government presented no evidence to refute the methodology petitioner used to estimate the asset's fair market value, and the uncontroverted evidence presented at trial revealed that "paid subscribers" had substantial value over and above that of a mere list of customers, as it was mistakenly characterized by the Government. Pp. 20-24.

945 F.2d 555, reversed and remanded.

JUDGES: BLACKMUN, J., delivered the opinion of the Court, in which STEVENS, O'CONNOR, KENNEDY, and THOMAS, JJ., joined. SOUTER, J., filed a dissenting opinion, in which REHNQUIST, C.J., and WHITE and SCALIA, JJ., joined.

OPINION BY: BLACKMUN

OPINION: [**295] JUSTICE BLACKMUN delivered the opinion of the Court.

This case presents the issue whether, under § 167 of the Internal Revenue Code, 26 U.S.C. § 167, [*5] the Internal Revenue Service (IRS) may treat as nondepreciable an intangible asset proved to have an ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy, solely because the IRS considers the asset to be goodwill as a matter of law. n1

----------Footnotes----------

n1 Section 167 states:

"(a) GENERAL RULE. -- There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) --

"(1) of property used in the trade or business, or

"(2) of property held for the production of income."

Treasury Regulations § 1.167(a)-(3) interprets § 167(a) and states:

"If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill." 26 CFR § 1.167(a)-3 (1992).

----------End Footnotes---------- [*6]

I

Petitioner Newark Morning Ledger Co., a New Jersey corporation, is a newspaper publisher. It is the successor to The Herald Company with which it merged in 1987. Eleven years earlier, in 1976, Herald had purchased substantially all the outstanding shares of Booth Newspapers, Inc., the publisher of daily and Sunday newspapers in

eight Michigan communities. n2 Herald and Booth merged on May 31, 1977, and Herald continued to publish the eight papers [**296] under their old names. Tax code provisions in effect in 1977 required that Herald allocate its adjusted income tax basis in the Booth shares among the assets acquired in proportion to their respective fair market values at the time of the merger. See 26 U.S.C. §§ 332 and 334(b)(2) (1976 ed.). n3

----------Footnotes----------

n2 The eight Michigan papers were The Ann Arbor News, The Bay City Times, The Flint Journal, The Grand Rapids Press, The Jackson Citizen Patriot, Kalamazoo Gazette, The Muskegon Chronicle, and The Saginaw News.

n3 Section 334(b)(2) was repealed in 1982 and replaced by the somewhat different provisions of the present § 338 of the Code.

----------End Footnotes---------- [*7]

Prior to the merger, Herald's adjusted basis in the Booth shares was approximately $ 328 million. Herald allocated $ 234 million of this to various financial assets (cash, securities, accounts and notes receivable, the shares of its wholly owned subsidiary that published Parade Magazine, etc.) and tangible assets (land, buildings, inventories, production equipment, computer hardware, etc.). Herald also allocated $ 67.8 million to an intangible asset denominated "paid subscribers." n4 This consisted of 460,000 identified subscribers to the eight Booth newspapers as of May 31, 1977, the date of merger. These subscribers were customers each of whom had requested that the paper be delivered regularly to a specified address in return for payment of the subscription price. The $ 67.8 million figure was petitioner's estimate of future profits to be derived from these at-will subscribers, all or most of whom were expected to continue to subscribe after the Herald acquisition. The number of "paid subscribers" was apparently an important factor in Herald's decision to purchase Booth and in its determination of the appropriate purchase price for the Booth shares. See Brief for Petitioner 4-5. [*8] After these allocations, the approximately $ 26.2 million remaining was allocated to going-concern value and goodwill.

----------Footnotes----------

n4 According to petitioner, the term "'paid subscribers' is intended to reflect the fact that the customers in question paid for their newspapers, rather than receiving them for free, and that they subscribed to the newspaper, requesting regular delivery, rather than purchasing it on a single copy basis." Brief for Petitioner 4, n. 5. The term does not connote subscription payments in advance; indeed, the customer relationship was terminable at will.

----------End Footnotes----------

On its federal income tax returns for the calendar years 1977-1980, inclusive, Herald claimed depreciation deductions on a straight-line basis for the $ 67.8 million allocated to "paid subscribers." The IRS disallowed these deductions on the ground that the concept of "paid subscribers" was indistinguishable from goodwill and, therefore, was nondepreciable under the applicable Regulations. Herald paid the resulting additional taxes. After the 1987 merger, [*9] petitioner filed timely claims for refund. The IRS took no action on the claims, and, upon the expiration of the prescribed 6-month period, see 26 U.S.C. § 6532(a)(1), petitioner brought suit in the District of New Jersey to recover taxes and interest that it claimed had been assessed and collected erroneously.

The case was tried to the court. Petitioner presented financial and statistical experts who testified that, using generally accepted statistical techniques, they were able to estimate how long the average at-will subscriber of each Booth newspaper as of May 31, 1977, would continue to subscribe. The estimates ranged from 14.7 years for a daily subscriber to The Ann Arbor News to [**297] 23.4 years for a subscriber to the Sunday edition of The Bay City Times. This was so despite the fact that the total number of subscribers remained almost constant during the tax years in question. The experts based their estimates on actuarial factors such as death, relocation, changing tastes, and competition from other media. The experts also testified that the value of "paid subscribers" was appropriately calculated using the "income approach." Under this, petitioner's [*10] experts first calculated the present value of the gross-revenue stream that would be generated by these subscriptions over their estimated useful lives. From that amount they subtracted projected costs of collecting the subscription revenue. Petitioner contended that the resulting estimated net-revenue stream -- calculated as $ 67,773,000 by one of its experts -- was a reasonable estimate of the value of "paid subscribers."

The Government did not contest petitioner's expert evidence at all. In fact, it stipulated to the estimates of the useful life of "paid subscribers" for each newspaper. Also, on valuation, the Government presented little or no evidence challenging petitioner's calculations. Instead, it argued that the only value attributable to the asset in question was the cost of generating 460,000 new subscribers through a subscription drive. Under this "cost approach," the Government estimated the value of the asset to be approximately $ 3 million.

The Government's principal argument throughout the litigation has been that "paid subscribers" represents an asset indistinguishable from the goodwill of the Booth newspapers. According to the Government, the future stream of revenue [*11] expected to be generated by the 460,000 "paid subscribers" represented the very essence of the goodwill value of the newspapers. It argued that because goodwill is nondepreciable, the value of "paid subscribers" cannot be depreciated but must be added to basis so that, when the business is disposed of, the cost of the asset will be deducted from the proceeds in computing capital gain or loss.

The District Court (Judge H. Lee Sarokin) ruled in petitioner's favor. 734 F. Supp. 176 (NJ 1990). It found as a fact that the "paid subscribers" asset was not self-regenerating -- it had a limited useful life the duration of which could be calculated with reasonable accuracy. Id., at 180. The court further found that the value of "paid subscribers" was properly calculated using the "income approach" and that the asset itself was separate and distinct from goodwill. "One must distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can be predicted to purchase the same item, for the same price on a daily basis." [*12] Id., at 176-177.

The Court of Appeals for the Third Circuit reversed. 945 F.2d 555 (1991). It concluded that the District Court had erred in defining goodwill as that which remains after all assets with determinable useful lives and ascertainable values have been accounted for. Id., at 568. The court concluded that goodwill has a substantive meaning -- the expectancy that "'old customers will resort to the old place' of business," id., at 567 -- [**298] and that "paid subscribers" is the essence of goodwill. Even though the "paid subscribers" asset may have a limited useful life that can be ascertained with reasonable accuracy, the court held that its value is not separate and distinct from goodwill. Id., at 568.

The Court of Appeals denied petitioner's suggestion for rehearing in banc, with two judges dissenting. See App. to Pet. for Cert. 52a. In order to resolve an issue of substantial importance under the Internal Revenue Code and to settle a perceived conflict, n5 we granted certiorari, 503 U.S. (1992).

----------Footnotes----------

n5 Compare the Third Circuit's ruling in the present case with Donrey, Inc. v. United States, 809 F.2d 534 (CA8 1987). See also Citizens & Southern Corp. v. Commissioner, 91 T.C. 463 (1988), aff'd, 919 F.2d 1492 (CA11 1990).

----------End Footnotes----------

II

Section 167(a) of the Code allows as a deduction for depreciation a reasonable allowance for the exhaustion and wear and tear, including obsolescence, of property used in a trade or business or of property held for the production of income. See n. 1, supra. This Court has held that "the primary purpose" of an annual depreciation deduction is "to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use (excluding maintenance expense) of the asset to the periods to which it contributes." Massey Motors, Inc. v. United States, 364 U.S. 92, 104, 4 L. Ed. 2d 1592, 80 S. Ct. 1411 (1960). The depreciation deduction has been a part of the federal tax system 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 of property, if any." Tariff of 1909, § 38 Second, 36 Stat. 113. Nothing in the text of the 1909 statute or in the implementing Treasury Decision precluded a depreciation allowance for intangible [*14] property. n6 This changed in 1914 with the promulgation of Treas. Regs. 33 (1914) issued under the 1913 Income Tax Law. n7

----------Footnotes----------

n6 According to the Treasury Department, the depreciation deduction "should be the estimated amount of the loss, accrued during the year to which the return relates, in the value of the property in respect of which such deduction is claimed that arises from exhaustion, wear and tear, or obsolescence out of the uses to which the property is put . . . . This estimate should be formed upon the assumed life of the property, its cost value, and its use." Treas. Regs. 31, Art. 4, p. 11 (1909).

n7 Treas. Regs. 33 provided explicitly that the depreciation deduction should be "estimated on the cost of the physical property with respect to which such deduction is claimed, which loss results from wear and tear due to the use to which the property is put" (emphasis added). Art. 159. Furthermore, "assets of any character whatever which are not affected by use, wear and tear (except patents, copyrights, etc.) are not subject to the depreciation allowance authorized by this act." Art. 162.

----------End Footnotes----------[*15]

The Revenue Act of 1918, § 234(a)(7), authorized a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." 40 Stat. 1078 (1919). Treas. Regs. 45 (1919), promulgated under the 1918 Act, explicitly recognized that intangible assets "may be the subject of a depreciation allowance." Art. 163. Thereafter, the Regulations governing [**299] the depreciation of intangible assets have remained essentially unchanged. The current version is set forth in n. 1, supra.

Since 1927, the IRS consistently has taken the position that "goodwill" is nondepreciable. n8 One court has said specifically: "Indeed, this proposition is so well settled that the only question litigated in recent years regarding this area of the law is whether a particular asset is 'goodwill.'" Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1247 (CA5 1973), cert. denied, 414 U.S. 1129, 38 L. Ed. 2d 754, 94 S. Ct. 867 (1974).

----------Footnotes----------

n8 Between 1919 and 1927, the IRS recognized that the goodwill of distillers and dealers might be depreciable as a result of the passage of the Eighteenth Amendment prohibiting the manufacture, sale, or transportation of intoxicating liquors. See T.B.R.

44, 1 C.B. 133 (1919). But in 1926, the Eighth Circuit, in Red Wing Malting Co. v. Willcuts, 15 F.2d 626, cert. denied, 273 U.S. 763, 71 L. Ed. 879, 47 S. Ct. 476 (1927), ruled that, under the plain language of the Revenue Act of 1918, goodwill could not be depreciated, for the depreciation provision "limits the allowance for obsolescence to such property as is susceptible to exhaustion, wear, and tear by use in the business, and good will is not such property." Id., at 633. Following Red Wing Malting, the Treasury Department amended its Regulations to provide: "No deduction for depreciation, including obsolescence, is allowable in respect of good will." T.D. 4055, VI-2 C.B. 63 (1927). That has been the position of the IRS ever since.

----------End Footnotes---------- [*16]

III

A

"Goodwill" is not defined in the Code or in any Treasury Department Regulations. There have been attempts, however, to devise workable definitions of the term. In Metropolitan Bank v. St. Louis Dispatch Co., 149 U.S. 436, 37 L. Ed. 799, 13 S. Ct. 944 (1893), for example, this Court considered whether a newspaper's goodwill survived after it was purchased and ceased publishing under its old name. It ruled that the goodwill did not survive, relying on Justice Story's notable description of "goodwill" as "'the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities, or prejudices.'" Id., at 446, quoting J. Story, Partnerships § 99 (1841).

In Des Moines Gas Co. v. Des Moines, 238 U.S. 153, 59 L. Ed. 1244, 35 S. Ct. 811 (1915), the Court [*17] described goodwill as "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." Id., at 165. See also Los Angeles Co. v. Railroad Comm'n, 289 U.S. 287, 313, 77 L. Ed. 1180, 53 S. Ct. 637 (1933) (distinguishing "going concern" from "good will" when fixing rates for public utilities).

Although the definition of goodwill has taken different forms over the years, the shorthand description of goodwill as "the expectancy of continued patronage," Boe v. Commissioner, 307 F.2d 339, 343 [**300] (CA9 1962), provides a useful label with which to identify the total of all the imponderable qualities that attract customers to the business. See Houston Chronicle Publishing Co. v. United States, 481 F.2d at 1248 , n. 5. This definition, however, is of little assistance to a taxpayer trying to evaluate which of its intangible assets is subject to a depreciation allowance. The value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will

continue [*18] their patronage. n9 But since 1918, at least some intangible assets have been depreciable. Because intangible assets do not exhaust or waste away in the same manner as tangible assets, taxpayers must establish that public taste or other socioeconomic forces will cause the intangible asset to be retired from service, and they must estimate a reasonable date by which this event will occur. See B. Bittker & M. McMahon, Federal Income Taxation of Individuals P 12.4, p. 12-10 (1988). Intangibles such as patents and copyrights are depreciable over their "legal lives," which are specified by statute. Covenants not to compete, leaseholds, and life estates, for example, are depreciable over their useful lives that are expressly limited by contract.

----------Footnotes----------

n9 We emphasize that while the "expectancy of continued patronage" is a serviceable description of what we generally mean when we describe an intangible asset that has no useful life and no ascertainable value, this shibboleth tells us nothing about whether the asset in question is depreciable. The dissent concedes that "the law concerning the depreciation of intangible assets related to goodwill has developed on a case-by-case basis," post, at 6 n. 4, yet, inexplicably, it suggests that "such matters are not at issue in this case, however, because the asset that Ledger seeks to depreciate is indistinguishable from goodwill," post, at 7, n. 4. As we demonstrate below, an intangible asset with an ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy, is depreciable under § 167 of the Code. The fact that it may also be described as the "expectancy of continued patronage" is entirely beside the point.

----------End Footnotes---------- [*19]

The category of intangibles that has given the IRS and the courts difficulty is that group of assets sometimes denominated "customer-based intangibles." This group includes customer lists, insurance expirations, subscriber lists, bank deposits, cleaning-service accounts, drugstore-prescription files, and any other identifiable asset the value of which obviously depends on the continued and voluntary patronage of customers. The question has been whether these intangibles can be depreciated notwithstanding their relationship to "the expectancy of continued patronage."

B

When considering whether a particular customer-based intangible asset may be depreciated, courts often have turned to a "mass asset" or "indivisible asset" rule. The rule provides that certain kinds of intangible assets are properly grouped and considered as a single entity; even though the individual components of the asset may expire or terminate over time, they are replaced by new components, thereby causing only minimal fluctuations and no measurable loss in the value of the whole. The following is the usually accepted description of a mass-asset:

"[A] purchased terminable-at-will type of customer list is an [*20] indivisible [**301] business property with an indefinite, nondepreciable life, indistinguishable from -- and the principal element of -- goodwill, whose ultimate value lies in the expectancy of continued patronage through public acceptance. It is subject to temporary attrition as well as expansion through departure of some customers, acquisition of others, and increase or decrease in the requirements of individual customers. A normal turnover of customers represents merely the ebb and flow of a continuing property status in this species, and does not within ordinary limits give rise to the right to deduct for 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." Golden State Towel & Linen Service, Ltd. v. United States, 179 Ct. Cl. 300, 310, 373 F.2d 938, 944 (1967).

The mass-asset rule prohibits the depreciation of certain customer-based intangibles because they constitute self-regenerating [*21] assets that may change but never waste. Although there may have been some doubt prior to 1973 as to whether the mass-asset rule required that any asset related to the expectancy of continued patronage always be treated as nondepreciable goodwill as a matter of law, that doubt was put to rest by the Fifth Circuit in the Houston Chronicle case. The court there considered whether subscription lists, acquired as part of the taxpayer's purchase of The Houston Press, were depreciable. The taxpayer had no intention of continuing publication of the purchased paper, so there was no question of the lists' being self-regenerating; they had value only to the extent that they furnished names and addresses of prospective subscribers to the taxpayer's newspaper. After reviewing the history of the mass-asset rule, the court concluded that there was no per se rule that an intangible asset is nondepreciable whenever it is related to goodwill. On the contrary, the rule does not prevent taking a depreciation allowance "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 [*22] limited useful life, the duration of which can be ascertained with reasonable accuracy." Id., at 1250.

Following the decision in Houston Chronicle, the IRS issued a new ruling, modifying prior rulings "to remove any implication that customer and subscription lists, location contracts, insurance expirations, etc., are, as a matter of law, indistinguishable from goodwill possessing no determinable useful life." Rev. Rul. 74-456, 1974-2 C.B. 65, 66. The IRS continued to claim that customer-based intangibles generally are in the nature of goodwill, representing "the customer structure of a business, their value lasting until an indeterminate time in the future." Nonetheless, it acknowledged that, "in an unusual case," the taxpayer may prove that the "asset or a portion thereof does not possess the characteristics of goodwill, is susceptible of valuation, and is of use to the taxpayer in its trade or business for only a limited period of time." [**302] Ibid. Under these circumstances, the IRS recognized the possibility that the customer-based intangible asset could be depreciated over its useful life.

Despite the suggestion by the Court [*23] of Appeals in this case that the mass-asset rule is "now outdated," 945 F.2d at 561 , it continues to guide the decisions of the Tax Court with respect to certain intangible assets. In Ithaca Industries, Inc. v. Commissioner, 97 T.C. 253 (1991), for example, the Tax Court recently considered whether a taxpayer could depreciate the value allocated to the trained work force of a purchased going concern over the length of time each employee remained with the purchasing company. The court acknowledged that "whether the assembled work force is an intangible asset with an ascertainable value and a limited useful life separate from goodwill or going-concern value is a question of fact." Id., at 263-264. After reviewing the record, it concluded that the mass-asset rule applied to prohibit the depreciation of the cost of acquiring the assembled work force:

"Although the assembled work force is used to produce income, this record fails to show that its value diminishes as a result of the passing of time or through use. As an employee terminated his or her employment, another would be hired and trained [*24] to take his or her place. While the assembled work force might be subject to temporary attrition as well as expansion through departure of some employees and the hiring of others, it would not be depleted due to the passage of time or as a result of use. The turnover rate of employees represents merely the ebb and flow of a continuing work force. An employee's leaving does not interrupt or destroy the continued existence of the whole." Id., at 267.

As a factual matter, the Tax Court found that the taxpayer hired a new worker only so he could replace a worker "who resigned, retired, or was fired." Id., at 268. The court found that the "assembled work force" was a nondiminishing asset; new employees were trained in order to keep the "assembled work force" unchanged, and the cost of the training was a deductible expense. Id., at 271.

IV

Since 1973, when Houston Chronicle clarified that the availability of the depreciation allowance was primarily a question of fact, taxpayers have sought to depreciate a wide variety of customer-based intangibles. The courts that have found these assets [*25] depreciable have based their conclusions on carefully developed factual records. In Richard S. Miller & Sons, Inc. v. United States, 210 Ct. Cl. 431, 537 F.2d 446 (1976), for example, the court considered whether a taxpayer was entitled to a depreciation deduction for 1,383 insurance expirations that it had purchased from another insurer. n10 The court concluded that the taxpayer [**303] had carried its heavy burden of proving that the expirations had an ascertainable value separate and distinct from goodwill and had a limited useful life, the duration of which could be ascertained with reasonable accuracy. The court acknowledged that the insurance expirations constituted a "mass asset" the useful life of which had to be "determined from facts relative to the whole, and not from experience with any particular policy or account involved." Id., at 443, 537 F.2d at 454 . The court also noted, however, that the mass-asset rule does not prevent a depreciation deduction "where the expirations as a single asset can be

valued separately and the requisite showing made that the useful life of the information [*26] contained in the intangible asset as a whole is of limited duration." Id., at 439, 537 F.2d at 452 . All the policies were scheduled to expire within three years, but their continuing value lay in their being renewable. Based on statistics gathered over a 5-year period, the taxpayer was able to estimate that the mass asset had a useful life of not more than 10 years from the date of purchase. Any renewals after that time would be attributable to the skill, integrity, and reputation of the taxpayer rather than to the value of the original expirations. "The package of expirations demonstrably was a wasting asset." Id., at 444, 537 F.2d at 455 . The court ruled that the taxpayer could depreciate the cost of the collection of insurance expirations over the useful life of the mass asset.

----------Footnotes----------

n10 An "expiration" is a copy of the face of an insurance policy made when the policy is issued. It shows the name of the insured, the type of insurance, the premium, the covered property, and the expiration date. "Its principal value in the insurance business is its indication of the most advantageous time to solicit a renewal." Richard S. Miller & Sons, Inc. v. United States, 210 Ct. Cl. at 436, 537 F.2d at 450 .

----------End Footnotes---------- [*27]

In Citizens & Southern Corp. v. Commissioner, 91 T.C. 463 (1988), aff'd, 919 F.2d 1492 (CA11 1990), the taxpayer argued that it was entitled to depreciate the bank-deposit base acquired in the purchase of nine separate banks. n11 The taxpayer sought to depreciate the present value of the income it expected to derive from the use of the balances of deposit accounts existing at the time of the bank purchases. The Commissioner argued that the value of the core deposits was inextricably related to the value of the overall customer relationship, that is, to goodwill. The Commissioner also argued that the deposit base consisted of purchased, terminable-at-will customer relationships that are equivalent to goodwill as a matter of law. The Tax Court rejected the Commissioner's position, concluding that the taxpayer had demonstrated with sufficient evidence that the economic value attributable to the opportunity to invest the core deposits could be (and, indeed, was) valued and that the fact that new accounts were opened as old accounts closed did not make the original purchased deposit base self-regenerating. Id., at 499. [*28]

----------Footnotes----------

n11 The term "deposit base" describes "the intangible asset that arises in a purchase transaction representing the present value of the future stream of income to be derived from employing the purchased core deposits of a bank." Citizens & Southern Corp. v. Commissioner, 91 T.C., at 465. The value of the deposit base rests upon the "ascertainable probability that inertia will cause depositors to leave their funds on deposit for predictable periods of time." Id., at 500.

----------End Footnotes----------

The court also concluded that, based on "lifing studies" estimating the percentage of accounts that would close over a given period of time, the taxpayer established that the deposit base had a limited useful life, the duration of which could be ascertained with reasonable accuracy. The taxpayer had established [**304] the value of the intangible asset using the cost-savings method, entitling it to depreciate that portion of the purchase price attributable to the present value of the difference [*29] between the ongoing costs associated with maintaining the core deposits and the cost of the market alternative for funding its loans and other investments. Id., at 510.

The Tax Court reached the same result in Colorado National Bankshares, Inc. v. Commissioner, 1990 Tax Ct. Memo LEXIS 548, 60 TCM 771, 1990 T.C. Memo 495 (1990), aff'd, F.2d (CA10 1993). The Tax Court concluded that

"the value of the deposit base does not depend upon a vague hope that customers will patronize the bank for some unspecified length of time in the future. The value of the deposit base rests upon the ascertainable probability that inertia will cause depositors to leave their funds on deposit for predictable periods of time." Id., at 789.

The court specifically found that the deposit accounts could be identified; that they had limited lives that could be estimated with reasonable accuracy; and that they could be valued with a fair degree of accuracy. They were also not self-regenerating. "It is these characteristics which separate them from general goodwill and permits separate valuation." Ibid. See also IT&S of Iowa, Inc. v. Commissioner, 97 T.C. 496, 509 (1991); [*30] Northern Natural Gas Co. v. O'Malley, 277 F.2d 128, 139 (CA8 1960) (concurring opinion).

The Eighth Circuit has considered a factual situation nearly identical to the case now before us. In Donrey, Inc. v. United States, 809 F.2d 534 (1987), the taxpayer sought to depreciate the subscription list of a newspaper it had purchased as a going concern. The taxpayer asserted that the subscription list was not simply a list of customers but "a machine to generate advertising revenue." Id., at 536. There was expert testimony that the value of the subscription list was "the present value of the difference in advertising revenues generated by the subscription list as compared to the revenues of an equivalent paper without a subscription list." Ibid. A jury found that the list had a limited useful life, the duration of which could be ascertained with reasonable accuracy; that the useful life was 23 years; and that it had an ascertainable value of $ 559,406 separate and distinct from goodwill. The District Court denied a motion for judgment notwithstanding the verdict after concluding that, [*31] although reasonable minds could have differed as to the correct result, there was evidence from which the jury could properly find for the taxpayer. The Court of Appeals implicitly rejected the Government's argument that the subscription list was necessarily inseparable from the value of

goodwill when it deferred to the jury's finding that the subscription list was depreciable because it had a determinable useful life and an ascertainable value.

V

A

Although acknowledging the "analytic force" of cases such as those discussed above, the Court of Appeals in the present case characterized them as "no more than a minority strand amid the phalanx of cases" that have adopted the Government's position on the meaning [**305] of goodwill. 945 F.2d at 565 . n12 "In any case, consistent with the prevailing case law, we believe that the IRS is correct in asserting that, for tax purposes, there are some intangible assets that, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." Id., at 568. The Court of Appeals concluded further that [*32] in "the context of the sale of a going concern, it is simply often too difficult for the taxpayer and the court to separate the value of the list qua list from the goodwill value of the customer relationships/structure." Ibid. We agree with that general observation. It is often too difficult for taxpayers to separate depreciable intangible assets from goodwill. But sometimes they manage to do it. And whether or not they have been successful in any particular case is a question of fact.

----------Footnotes----------

n12 At least one commentator has taken issue with the Court of Appeals' characterization of the recent cases as nothing but a "minority strand." See Avi-Yonah, Newark Morning Ledger: A Threat to the Amortizability of Acquired Intangibles, 55 Tax Notes 981, 984 (1992) (of the 14 cases cited by the Third Circuit that were decided after Houston Chronicle in 1973, the IRS has prevailed in only 6 of them; "hardly an 'overwhelming weight of authority' in the IRS' favor, especially given that two of the IRS victories, but none of the taxpayers,' were only at the district court level"). Regardless of whether the cases discussed in Part IV, supra, are characterized as a "minority strand" or as a "modern trend," we find their reasoning and approach persuasive.

----------End Footnotes---------- [*33]

The Government concedes: "The premise of the regulatory prohibition against the depreciation of goodwill is that, like stock in a corporation, a work of art, or raw land, goodwill has no determinate useful life of specific duration." Brief for United States 13. See also Richard S. Miller & Sons, Inc. v. United States, 210 Ct. Cl. at 437, 537 F.2d at 450 ("Goodwill is a concept that embraces many intangible elements and is presumed to have a useful life of indefinite duration"). The 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. It is more faithful to the purposes of the Code to allow the depreciation deduction under these circum-

stances, for "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," INDOPCO, Inc. v. Commissioner, 503 U.S. , (1992) (slip op. 5). n13

----------Footnotes----------

n13 The dissent suggests that we are usurping the proper role of Congress by seeking to "modify the per se ban on depreciating goodwill," post, at 13, n. 10. But we are doing nothing of the kind. We simply have determined that, in light of the factual record in this case, the "paid subscribers" asset is depreciable. The dissent's mistake is to assume that because the "paid subscribers" asset looks and smells like the "expectancy of continued patronage," it is, ipso facto, nondepreciable. In our view, however, whether or not an asset is depreciable is not a question to be settled by definition. "Goodwill" remains nondepreciable under applicable regulations, and we do not purport to change that fact. In interpreting those regulations, however, we have concluded that because the "paid subscribers" is an asset found to have a limited useful life and an ascertainable value which may be determined with reasonable accuracy, it is depreciable. By definition, therefore, it is not "goodwill."

----------End Footnotes---------- [*34]

In the case that first established the principle that goodwill [**306] was not depreciable, the Eighth Circuit recognized that the reason for treating goodwill differently was simple and direct: "'As good will does not suffer wear and tear, does not become obsolescent, is not used up in the operation of the business, depreciation, as such, cannot be charged against it.'" Red Wing Malting Co. v. Willcuts, 15 F.2d 626, 633 (1926) (citation omitted), cert. denied, 273 U.S. 763, 71 L. Ed. 879, 47 S. Ct. 476 (1927). See also 5 J. Mertens, The Law of Federal Income Taxation § 23A.01, p. 7 (1992) ("Goodwill is not amortizable intangible property because its useful life cannot be ascertained with reasonable accuracy" (emphasis added)). It must follow that if a taxpayer can prove with reasonable accuracy that an asset used in the trade or business or held for the production of income has a value that wastes over an ascertainable period of time, that asset is depreciable under § 167, regardless of the fact that its value is related to the expectancy of continued patronage. The significant question for purposes of depreciation is not whether the asset falls "within [*35] the core of the concept of goodwill," Brief for United States 19, but whether the asset is capable of being valued and whether that value diminishes over time. In a different context, the IRS itself succinctly articulated the relevant principle: "Whether or not an intangible asset, or a tangible asset, is depreciable for Federal income tax purposes depends upon the determination that the asset is actually exhausting, and that such exhaustion is susceptible of measurement." Rev. Rul. 68-483, 1968-2 Cum. Bull. 91-92.

B

Although we now hold 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, we do not mean to imply that the taxpayer's burden of proof is insignificant. On the contrary, that burden often will prove too great to bear. See, e. g., Brief for Coopers & Lybrand as Amicus Curiae 11 ("For example, customer relationships arising from newsstand sales cannot be specifically identified. In [our] experience, customers were identified but their [*36] purchases were too sporadic and unpredictable to reasonably ascertain either the duration of the relationships or the value of the relationships (based on their net income stream)" (emphasis in original)).

Petitioner's burden in this case was made significantly lighter by virtue of the Government's litigation strategy:

"Because of the stipulation reached by the parties, Morning Ledger need not prove either the specific useful lives of the paid subscribers of the Booth newspapers as of May 31, 1977, or that Dr. Glasser [its statistical expert] has correctly estimated those lives. In light of the stipulation, [the Government's] argument with regard to Dr. Glasser's estimation of the specific useful lives of the Booth subscribers is wholly irrelevant. Instead, Dr. Glasser's testimony establishes that qualified experts could estimate with reasonable accuracy the remaining useful lives of the paid subscribers of the Booth newspapers as of May 31, 1977." 734 F. Supp. at 181 .

[**307] Petitioner also proved to the satisfaction of the District Court that the "paid subscribers" asset was not self-regenerating, thereby distinguishing it for purposes of applying the [*37] mass-asset rule:

"There is no automatic replacement for a subscriber who terminates his or her subscription. Although the total number of subscribers may have or has remained relatively constant, the individual subscribers will not and have not remained the same, and those that may or have discontinued their subscriptions can be or have been replaced only through the substantial efforts of the Booth newspapers." Id., at 180.

The 460,000 "paid subscribers" constituted a finite set of subscriptions, existing on a particular date -- May 31, 1977. The asset was not composed of constantly fluctuating components; rather, it consisted of identifiable subscriptions each of which had a limited useful life that could be estimated with reasonable accuracy according to generally accepted statistical principles. Petitioner proved as a matter of fact that the value of the "paid subscribers" diminished over an ascertainable period of time. n14

----------Footnotes----------

n14 The dissent spends a substantial amount of time worrying about the sufficiency of petitioner's evidence. See post, at 7-13. The problem with petitioner's expert, according to the dissent, is that he predicted only how long a subscriber is likely to subscribe,

and this "tells us nothing about how long date-of-sale subscriber habit or inertia will remain a cause of predicted subscriber faithfulness." Post, at 12. The dissent concludes that "Ledger's expert on his own terms has not even claimed to make the showing of definite duration necessary to depreciate an asset under § 167(a)." Post, at 12. We have little doubt that had the Government presented credible evidence challenging the relevance of this testimony, the District Court would have had a more difficult time deciding this case. As it happened, however, petitioner's evidence of the useful life of the "paid subscribers" was the only evidence the District Court had before it. The dissent skillfully demonstrates certain vulnerabilities in petitioner's proof, but the Government chose, rather, to rest its entire case on a legal argument that we now reject. This case was lost at trial.

----------End Footnotes---------- [*38]

C

Petitioner estimated the fair market value of the "paid subscribers" at approximately $ 67.8 million. This figure was found by computing the present value of the after-tax subscription revenues to be derived from the "paid subscribers," less the cost of collecting those revenues, and adding the present value of the tax savings resulting from the depreciation of the "paid subscribers." As the District Court explained, the taxpayer's experts "utilized this method because they each independently concluded that this method best determined the additional value of the Booth newspapers attributable to the existence of the paid subscribers as of May 31, 1977, and, thus, the fair market value of those subscribers." Id., at 183. The Government presented no evidence challenging the accuracy of this methodology. It took the view that the only value attributable to the "paid subscribers" was equivalent to the cost of generating a similar list of new subscribers, and it estimated that cost to be approximately $ 3 million. The Court of Appeals agreed with the Government that this "cost approach" was the only appropriate method for valuing the list of subscribers. [*39] "The fact is that, when employed in the context of the sale of [**308] an ongoing concern, the income approach to valuing a list of customers inherently includes much or all of the value of the expectancy that those customers will continue their patronage -- i.e., the goodwill of the acquired concern." 945 F.2d at 568 .

Both the Government and the Court of Appeals mischaracterized the asset at issue as a mere list of names and addresses. The uncontroverted evidence presented at trial revealed that the "paid subscribers" had substantial value over and above that of a mere list of customers. App. 67 (Price Waterhouse's Fair Market Value Study of Paid Newspaper Subscribers to Booth Newspapers as of May 31, 1977); id., at 108-111 (testimony of Roger J. Grabowski, Principal and National Director, Price Waterhouse Valuation Services). These subscribers were "seasoned"; they had subscribed to the paper for lengthy periods of time and represented a reliable and measurable source of revenue. In contrast to new subscribers, who have no subscription history and who might not last beyond the expiration of some promotional incentive, the "paid subscrib-

ers" at issue here [*40] provided a regular and predictable source of income over an estimable period of time. The cost of generating a list of new subscribers is irrelevant, for it represents the value of an entirely different asset. We agree with the District Court when it concluded:

"Although it was possible to estimate the direct cost of soliciting additional subscribers to the Booth newspapers, those subscribers if obtained were not and would not have been comparable, in terms of life characteristics or value, to the paid subscribers of the Booth newspapers as of May 31, 1977. . . . The cost of generating such marginal subscribers would not reflect the fair market value of the existing subscribers of the Booth newspapers as of May 31, 1977." 734 F. Supp. at 181 .

Because it continued to insist that petitioner had used the wrong valuation methodology, the Government failed to offer any evidence to challenge the accuracy of petitioner's application of the "income approach." The District Court found that the aggregate fair market value of the "paid subscribers" of the Booth newspapers as of May 31, 1977 -- i.e., "the price at which the asset would change hands between [*41] a hypothetical willing buyer and willing seller, neither being under any compulsion to buy or sell, both parties having reasonable knowledge of relevant facts," id., at 185 -- was $ 67,773,000, with a corresponding adjusted income tax basis of $ 71,201,395. Petitioner was entitled to depreciate this adjusted basis using a straight-line method over the stipulated useful lives.

VI

Petitioner has borne successfully its substantial burden of proving that "paid subscribers" constitutes an intangible asset with an ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy. It has proved that the asset is not self-regenerating but rather wastes as the finite number of component subscriptions are canceled over a reasonably predictable period of time. The relationship this asset may have to the expectancy of continued [**309] patronage is irrelevant, for it satisfies all the necessary conditions to qualify for the depreciation allowance under § 167 of the Code.

The judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

DISSENT BY: SOUTER

DISSENT: [*42] JUSTICE SOUTER, with whom THE CHIEF JUSTICE, JUSTICE WHITE, and JUSTICE SCALIA join, dissenting.

Newark Morning Ledger seeks a depreciation n1 deduction under 26 U.S.C. § 167(a) for an intangible asset it variously refers to as "paid subscribers," see Brief for Petitioner 4-5, or "subscriber relationships," see Tr. of Oral Arg. 3. The Court of Appeals rejected Ledger's claim on the authority of a Treasury regulation providing (a) that an intangible asset may be depreciated only if it has a limited useful life "the length of which can be estimated with reasonable accuracy," and (b) that "no deduction for depreciation is allowable with respect to goodwill." 26 CFR § 1.167(a)-3 (1992); see 945 F.2d 555, 558, 567-569 (CA3 1991). Ledger claims the regulation raises no bar to a deduction, arguing that (1) the asset is not goodwill, because (2) it has a limited useful life actually estimated with reasonable accuracy. Ledger is wrong on both counts. Ledger's asset is unmistakably a direct measurement of goodwill, and Ledger's expert testimony failed to show any particular lifespan for the goodwill Ledger acquired.

----------Footnotes----------

n1 Black's Law Dictionary tells us that intangible assets are amortized, while tangible assets are depreciated. Black's Law Dictionary 83, 441 (6th ed. 1990); see also Gregorcich, Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill, 28 Tax Lawyer 251, 253 (1975) ("Amortization is the commonly accepted way of referring to depreciation of intangible property"). The statute and the regulations, however, use only the term depreciation.

----------End Footnotes---------- [*43]

I

When the Herald Company (now merged with Newark Morning Ledger) bought and liquidated the stock of Booth Newspapers, Inc., it allocated $ 67.8 million of the stock's adjusted basis to an asset called "paid subscribers." Although, as will appear, this label is misdescriptive, it need not confuse anyone about the true nature of the asset, since Ledger has explained clearly how it determined the asset's value. Ledger got to the $ 67.8 million figure by predicting the future net revenues to be generated by the 460,000 people who subscribed to the eight Booth newspapers as of the date of sale, May 31, 1977. Because these customers had neither paid in advance nor agreed to subscribe for any set term, see Brief for Petitioner 4, n. 5; ante, at 2-3, n. 4, they were merely at-will subscribers; the value of their expected future custom was capitalized as the asset Ledger seeks to depreciate.

However much Ledger claims this asset to be something different from "goodwill," the settled meaning of the term is flatly at odds with Ledger's contention. Since the days of Justice Story, we have understood the concept of "goodwill" to be anchored in the patronage a business [**310] receives from "constant [*44] or habitual" customers. See, e. g., Metropolitan Bank v. St. Louis Dispatch Co., 149 U.S. 436, 446, 37 L. Ed. 799, 13 S. Ct. 944 (1893); Des Moines Gas Co. v. Des Moines, 238 U.S. 153, 59 L. Ed. 1244, 35 S. Ct. 811 (1915); see also Cruttwell v. Lye, 17 Ves. Jr. 335, 346, 34 Eng.

Rep. 129, 134 (Ch. 1810) (opinion of Lord Eldon) (goodwill is "nothing more than the probability, that the old customers will resort to the old place"). Although this Court has not had occasion to provide a precise definition of the term as it appears in the depreciation regulation, the courts of appeals have consistently held that "goodwill," in this context, refers to "the expectancy of continued patronage" from existing customers or, alternatively, to the prospect that "the old customers will resort to the old place." See, e. g., Winn-Dixie Montgomery, Inc. v. United States, 444 F.2d 677, 681 (CA5 1971); Commissioner v. Seaboard Finance Co., 367 F.2d 646, 649 (CA9 1966); Boe v. Commissioner, 307 F.2d 339, 343 (CA9 1962); Dodge Brothers, Inc. v. United States, 118 F.2d 95, 101 (CA4 1941); [*45] see also Golden State Towel and Linen Service, Ltd. v. United States, 179 Ct. Cl. 300, 305-309, 373 F.2d 938, 941-943 (1967); Karan v. Commissioner, 319 F.2d 303, 306 (CA7 1963) (goodwill denotes an expectancy that a customer relationship will continue "without contractual compulsion"). Thus, the Government justifiably concludes that "goodwill," as used in its own regulation, refers to the expectation of continued patronage by existing customers. See Brief for United States 16-19.

Under this accepted definition of "goodwill," there can be no doubt that the asset Ledger calls "paid subscribers" or "subscriber relationships" is simply the goodwill associated with those subscribers. Once this is clear, it becomes equally clear that Ledger should lose, since the intangible asset regulation expressly and categorically bars depreciation of goodwill, and courts have uniformly relied on that regulation's plain language to conclude that goodwill is nondepreciable as a matter of law. See Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1247 (CA5 1973) (the [*46] proposition that goodwill is nondepreciable as a matter of law "is so well settled that the only question litigated in recent years regarding this area of the law is whether a particular asset is 'goodwill' "), cert. denied, 414 U.S. 1129, 38 L. Ed. 2d 754, 94 S. Ct. 867 (1974); see also Donrey, Inc. v. United States, 809 F.2d 534, 536 (CA8 1987) (goodwill "is ineligible per se for the depreciation deduction"); Richard S. Miller & Sons, Inc. v. United States, 210 Ct. Cl. 431, 437, 537 F.2d 446, 450 (1976) ("the presumption that [goodwill] is a nondepreciable capital asset is conclusive"); Boe v. Commissioner, supra, at 343 ("good will is not a depreciable asset").

II

Ledger tries to slip out of this predicament by two separate steps. It argues first that the Court ought to adopt a new definition of "goodwill" that would not cover any expectation of future custom with a lifespan subject to definite advance estimate; then it claims that the asset here falls outside the new definition because Ledger's expert has predicted the length of the asset's [**311] wasting life with reasonable [*47] accuracy. See Brief for Petitioner 12-13. The Court makes a serious mistake in taking the first step; Ledger should lose in any event, however, since its expert has failed to furnish the basis for taking the second.

A

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. See id., at 19, 29-30 (relying on accounting standards).

In accommodating Ledger on this point, see ante, at 18-19, n. 13, the Court abandons the settled construction of a regulation more than 65 years old, n2 see Treas. Dec. Int. Rev. 4055, VI-2 C.B. 63 (1927), and repudiates the equally settled interpretation of the corresponding section of the tax code itself. We are, after all, dealing with a statute reenacted without substantial change not less than six times since 1919, see Revenue Act of 1918, § 234(a)(7), 40 Stat. 1078 (1919); Revenue Act [*48] of 1932, § 23(k), 47 Stat. 181; Revenue Act of 1934, § 23(l), 48 Stat. 689; Revenue Act of 1936, § 23(l), 49 Stat. 1660; Revenue Act of 1938, § 23(l), 52 Stat. 462; Internal Revenue Code of 1939, § 23(l), 53 Stat. 14; Internal Revenue Code of 1954, § 167(a), 68A Stat. 51, and we may presume that Congress has accepted the understanding set out in the cognate intangible asset regulation and in the judicial decisions that have clarified that regulation's [**312] terms. n3 Lorillard v. Pons, 434 U.S. 575, 580, 55 L. Ed. 2d 40, 98 S. Ct. 866 (1978); United States v. Correll, 389 U.S. 299, 305-306, 19 L. Ed. 2d 537, 88 S. Ct. 445 (1967); Helvering v. Winmill, 305 U.S. 79, 83, 83 L. Ed. 52, 59 S. Ct. 45 (1938). The consequences, therefore, of acceding to Ledger's argument are at once a rejection of statutory interpretation settled by Congress itself through reenactment of the tax code and a further invasion of the political domain to rewrite a Treasury regulation. n4 See Correll, supra, at 307 (this Court will defer to a tax regulation so long as it "implements the congressional mandate in some reasonable manner"); National Muffler Dealers Assn., Inc. v. United States, 440 U.S. 472, 477, 59 L. Ed. 2d 519, 99 S. Ct. 1304 (1979) [*49] (listing historical considerations that may give a regulation "particular force"); see also Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843-845, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984) (reasonable agency interpretations of statutory provisions will be upheld).

----------Footnotes----------

n2 The current intangible asset regulation can be traced back to Treasury Regulation 45, issued in 1919, which provided that there could be no deduction "in respect of good will" under the general depreciation provision of the Revenue Act of 1918 because goodwill was an example of an asset that did not have a useful life "definitely limited in duration." Treas. Dec. Int. Rev. 2831, 21 Treas. Dec. 214, Art. 163. The Commissioner dropped the reference to goodwill for a few years, in response to attempts by distillers and brewers to depreciate goodwill made obsolete by the adoption of the Eighteenth Amendment. See T. D. 2929, 1 C.B. 133 (1919); see also Treas. Dec. Int. Rev. 3146, 23 Treas. Dec. 402, Art. 163 (1920) (reflecting this change). The first Court of Appeals to address the subject, however, held that goodwill could not be depreciated under the

Revenue Act of 1918 because it was not susceptible to exhaustion or wear and tear, as required by the statute. Red Wing Malting Co. v. Willcuts, 15 F.2d 626 (CA8 1926), cert. denied, 273 U.S. 763, 71 L. Ed. 879, 47 S. Ct. 476 (1927). Shortly after that decision, the Commissioner amended the intangible asset regulation by adding the following prohibition: "No deduction for depreciation, including obsolescence, is allowable in respect of good will." T.D. 4055, VI-2 C.B. 63 (1927). It has remained there ever since. See, e. g., Treas. Regs. 77, Art. 203 (Revenue Act of 1932); Treas. Regs. 86, Art. 23(l)-3 (Revenue Act of 1934); Treas. Regs. 94, Art. 23(l)-3 (Revenue Act of 1936); Treas. Regs. 103, § 19.23(l)-3 (Internal Revenue Code of 1939); 26 CFR § 1.167(a)-3 (1961) (Internal Revenue Code of 1954).

Although Red Wing Malting provoked a circuit split, this Court resolved the conflict a few years later by deciding, in line with the Commissioner's amended regulation, that a brewery could not deduct for the "exhaustion" or "obsolescence" of goodwill as a result of Prohibition. See Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384, 74 L. Ed. 498, 50 S. Ct. 155 (1930); Renziehausen v. Lucas, 280 U.S. 387, 74 L. Ed. 501, 50 S. Ct. 156 (1930); see also V. Loewers Gambrinus Brewery Co. v. Anderson, 282 U.S. 638, 75 L. Ed. 588, 51 S. Ct. 260 (1931) (distinguishing Haberle Springs and allowing a brewery to claim a depreciation deduction for buildings made obsolete by Prohibition). [*50]

n3 Legislative materials indicate that Congress is, in fact, aware of the accepted definition of "goodwill." See, e. g., H. R. Conf. Rep. No. 100-495, p. 937 (1987) ("Goodwill has been defined as the expectancy of continued patronage, for whatever reason, or as the probability that old customers will resort to the old place").

n4 The majority discounts these consequences by claiming that the utility of the accepted definition of "goodwill" is limited because "the value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will continue their patronage." Ante, at 9. But the regulation does not provide that every intangible asset related to goodwill is nondepreciable; rather, it simply states that goodwill itself is nondepreciable. Subject to this prohibition, the law concerning the depreciation of intangible assets related to goodwill has developed on a case-by-case basis, and the Government has accepted some of the distinctions that courts have drawn, including the principle that customer lists sold separately from a going business may be depreciable. See Brief for United States 36, n. 34; Rev. Rul. 74-456, 1974-2 C.B. 65, 66 (modifying earlier rulings "to remove any implication that customer and subscription lists, location contracts, insurance expirations, etc., are, as a matter of law, indistinguishable from goodwill"). Such matters are not at issue in this case, however, because the asset that Ledger seeks to depreciate is indistinguishable from goodwill. See 945 F.2d 555, 568 (CA3 1991) (Newark Morning Ledger did not attempt, in this case, to claim a separate depreciation allowance for the subscriber lists it acquired).

----------End Footnotes----------[*51]

I cannot deny, however, that the regulation would suffer real internal tension between its specific, categorical treatment of goodwill and its general analytical test (turning on the existence of a limited life of ascertainable duration), if modern accounting techniques were to develop a subtlety sufficient to make an accurate estimate of goodwill's useful life. Fortunately or not, however, the record in this case raises no such tension.

B

Even under Ledger's revision of the regulation, a depreciation deduction would depend on showing the Booth newspapers' goodwill to have a useful life both limited and measurable with some reasonable degree of certainty. The further step needed for victory is thus evidentiary in nature, and Ledger's success or failure is solely a function of the evidentiary record. Ledger has failed.

Here, it is helpful to recall one defining characteristic of the only kind of asset Ledger claims to be [**313] entitled to depreciate: it must be an asset acquired from Booth Newspapers, Inc. upon the sale of its stock to Ledger's predecessor, Herald. If the goodwill is to be depreciated at all, in other words, it must be goodwill purchased, not goodwill attributable to anything [*52] occurring after the purchase date. It must be an expectation of continued patronage as it existed when the old Booth newspapers changed hands.

Assuming that there is a variety of goodwill that may be separately identified as an asset on the date of sale, some limitation on its useful life may be presumed. Whatever may be the force of habit, or inertia, that is valued as goodwill attributable to events occurring before the date of sale, the influence of those events wanes over time, and so must the habit or inertia by which that influence is made manifest and valued as goodwill. On the outside, the economically inert subscribers will prove to be physically mortal. n5

----------Footnotes----------

n5 While some courts have viewed goodwill as having an indefinite useful life, others have concluded that although goodwill does waste, its useful life cannot be determined with reasonable accuracy. Compare, e. g., Red Wing Malting, 15 F.2d at 633 (goodwill is not depreciable because it "does not suffer wear and tear, does not become obsolescent, [and] is not used up in the operation of the business"); Patterson v. Commissioner, 810 F.2d 562, 569 (CA6 1987) (goodwill "does not waste"); Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1248 (CA5 1993) (goodwill is "an ongoing asset that fluctuates but does not necessarily diminish"); Landsberger v. McLaughlin, 26 F.2d 77, 78 (CA9 1928) (goodwill is not subject to exhaustion, wear or tear) with, e. g., Dodge Brothers, Inc. v. United States, 118 F.2d 95, 100 (CA4 1941) (goodwill is not depreciable because of "manifest difficulties" inherent in estimating its life span); Illinois Cereal Mills, Inc. v. Commissioner, 1983 T.C. Memo 469, 46 TCM 1001, 1023

(1983), P 83,469 P-H Memo TC (goodwill is not subject to depreciation "because [its] useful life is not susceptible of reasonable estimation").

----------End Footnotes---------- [*53]

What the Government does not concede, n6 however, and what Ledger has not proven, is the duration of that date-of-sale influence and consequent goodwill. Ledger, indeed, has not even purported to show that. Instead, its expert has estimated the quite different periods over which subscribers on the date of sale will continue to subscribe to the various [**314] papers. n7 In the District Court, Ledger offered a single witness for its claim to have estimated the useful life of each newspaper's "subscriber relationships" with reasonable accuracy. Herald had originally hired that witness, Dr. Gerald Glasser, to predict the average remaining lives of existing subscriptions to the eight Booth newspapers. See App. in No. 90-5637 (CA3), p. 1010. Dr. Glasser testified that he first compiled statistics on the length of time existing subscribers had received each newspaper, by directing a survey that asked a selection of those subscribers one central question: "For how long has the [newspaper] been delivered to your present address?" Id., at 157, 166, 182-183, 1012. He then made a crucial assumption, that the total number of subscriptions to each newspaper would remain stable over time. Id., [*54] at 170-172, 187, 194-195. Finally, by subjecting the survey results to techniques of statistical analysis based on this crucial assumption, Dr. Glasser produced a series of figures that, he said, represented the average remaining life of existing subscriptions to each newspaper. Solely on the basis of Dr. Glasser's testimony, the District Court held that "the remaining useful lives of the paid subscribers of the Booth newspapers as of May 31, 1977, could be estimated with reasonable accuracy." 734 F. Supp. 176, 181 (NJ 1990).

----------Footnotes----------

n6 In an effort to insulate the case from review, Ledger asserts a concession by the Government below that the asset Ledger wants to depreciate did have a limited useful life that was estimated with reasonable accuracy. Brief for Petitioner 17, and n. 18. The majority does not go quite so far when it observes that "petitioner's burden in this case was made significantly lighter by virtue of the Government's litigation strategy." Ante, at 20. In any event, the District Court's description of the Government's strategy makes it clear that the Government has not conceded this case away:

"The parties have agreed that, if the Court determines that the paid subscribers constitute assets which were separate and apart from goodwill and which can be valued separate and apart from goodwill, and if the Court determines that the paid subscribers had useful lives which can be estimated with reasonable accuracy, then the paid subscribers of the Booth newspapers can be depreciated on a straight-line basis over the . . . useful lives [shown in the accompanying chart]." 734 F. Supp. 176, 180 (NJ 1990).

Thus, the factual concession by the Government came into play only after the District Court rejected two crucial legal arguments: (1) the "paid subscribers" asset is not an asset separate and distinct from goodwill, and (2) the asset did not have a useful life that could be estimated with reasonable accuracy. I find, for the reasons set out in the text, that the District Court erred in rejecting each argument. I also note that a similar litigating strategy did not prevent the Government from prevailing in Haberle Springs. See 280 U.S. at 386 ("The amount of the deduction to be made is agreed upon if any deduction is to be allowed"). [*55]

n7 The estimates vary from paper to paper, but I refer to them in the singular, consistently with Ledger's claim to a singular "asset."

----------End Footnotes----------

Dr. Glasser's assumption is the key not only to the results he derived, but to the irrelevance of those results to the predictable life on the date of sale of the goodwill (or "paid subscribers") actually purchased from Booth. The key, in turn, to that irrelevance lies not in Dr. Glasser's explicit statement of his assumption, but in what the assumption itself presupposes. Since the District Court was not concerned with predicting the value that any given Booth newspaper might have in the future (as distinct from predicting the useful life of pre-existing subscriber goodwill), an assumption that the level of a paper's subscriptions would remain constant was useful only insofar as it had a bearing on predicting the behavior of the old subscribers. For this purpose, assuming a constant subscription level was a way of supposing that a given newspaper would remain as attractive to subscribers in the future as it had been during the period prior to the newspaper's sale. [*56] The assumption was thus a surrogate for the supposition that the new owners would not rock the boat and would succeed in acting intelligently to keep the paper, if not exactly as it had always been, at least as relatively attractive as it had been in relation to its various competitors on the date of sale.

What is significant about this assumption for present purposes is not its doubtful validity, n8 but the very [**315] fact of its being an assumption about the behavior of the paper's management after the date of sale. And since this assumption is the basis for a prediction about the life of subscriptions existing on the date of sale, that prediction is by definition not simply about the duration of subscriber goodwill (or habit or inertia) as it existed on the date the paper changed hands. On the contrary, it is a prediction about the combined effect of pre-sale goodwill and post-sale satisfaction with the paper as Ledger presumably continues to produce it. Nowhere in Dr. Glasser's testimony do we find an opinion that the pre-sale goodwill has a life coextensive with the predicted life of the subscriptions, and nowhere do we find an opinion about the point at which the old goodwill finally [*57] peters out as a measurable, and hence valuable, influence on the old subscribers' behavior. It is not, of course, important for present purposes whether such an opinion would be possible, though I am skeptical that it would be. n9 But it is important that no such evidence exists in this case. In place of evidence showing the depreciable lifespan of date-of-sale goodwill with a reasonable degree of accu-

racy, Ledger has presented evidence of how long an old subscriber will remain one, on the assumption that the subscriber's prior satisfaction is confirmed, and (for all we know) replaced, with satisfaction resulting from Ledger's publishing performance over the years following its acquisition of a given newspaper.

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n8 No matter how much pre-sale satisfaction subscribers have, it seems intuitively obvious that a high enough level of post-sale dissatisfaction with a paper would drive subscribers away, as might other post-sale events, such as successful competition and demographic changes. The District Court, relying on Ledger's own witnesses, noted several of the many possible reasons that lead subscribers to cancel their subscriptions:

"Subscribers are lost because of death, relocation, lack of reader time or interest, changing lifestyles, and other factors that are beyond the control of the newspapers. Also, subscribers are lost due to dissatisfaction with the product or service and for various other reasons, including competition from other media sources, such as radio, television, magazines and other paid-circulation and/or free-distribution newspapers." 734 F. Supp. at 180 .

Ledger's statistician, in effect, made an assumption regarding Ledger's ability to manage the innumerable factors that keep current customers coming back for more, as well as its ability to attract new customers as the old ones leave. Such discretionary decisions may turn out to be foolish or wise: if foolish, the subscriber base as of the date of sale could be destroyed rapidly; if wise, it would be maintained. The simple recognition that some papers increase their subscriber base over time, while others lose it (and some actually fold), underscores the arbitrariness of the assumption made by Ledger's expert witness. In any event, Ledger has provided no evidence to support this assumption.

I do not, of course, suggest that a buyer's treatment of a depreciable asset does not affect the asset's actual useful life. A machine's less durable parts must be replaced; it must be oiled, kept from the weather, given fuel, and so on. But there is an identifiable object that endures through time and does not just disappear from inadequate maintenance. Goodwill, on the other hand, can be destroyed rapidly by everything from the nasty personality of a new proprietor to distaste for his publishing policies. Prediction of goodwill's endurance must always be fraught with a relatively high degree of chance, for discretionary decisions, rather than just ministerial acts (like oiling the gears), must be taken into account. [*58]

n9 Goodwill results from such a mix of influences over time that it seems unlikely that the skein of them all could be untangled to identify the degree to which even present custom results from the goodwill purchased, as distinct from goodwill subsequently cultivated. Ledger has not even attempted such a disentanglement.

----------End Footnotes----------

This, of course, misses the point entirely. In telling us merely how long a subscriber is likely to subscribe, Ledger tells us nothing about how long date-of-sale subscriber habit or inertia will remain a cause of predicted subscriber faithfulness. Since, however, only the date-of-sale probability of faithfulness could be entitled to depreciation as a purchased asset, Ledger's expert on his own terms has not even claimed to make the showing of definite duration [**316] necessary to depreciate an asset under § 167(a). Indeed, once duration of subscriptions and purchased goodwill are seen to be conceptually different, Ledger's claim to have satisfied the requirements for depreciating an intangible asset simply vanishes. Ledger's entire case thus rests on the confusion of subscription duration [*59] with goodwill on the date of sale, and only that confusion could suggest that Ledger has shouldered its burden of estimating the lifespan of the asset purchased from Booth. It is not surprising, then, that the Commissioner has stood by her categorical judgment that goodwill is not depreciable, that Congress has not disturbed this judgment, n10 and that lower courts have consistently agreed that goodwill is nondepreciable as a matter of law.

----------Footnotes----------

n10 The majority claims its approach to be "more faithful to the purposes of the Code," in allowing taxpayers to make a better match of expenses with revenues. Ante, at 18 (citing INDOPCO, Inc. v. Commissioner, 503 U.S. · (1992)). Such policy initiatives are properly left to Congress, which can modify the per se ban on depreciating goodwill at any time. Despite several recent opportunities to do so, Congress has so far refused to alter the tax treatment of goodwill and other intangibles. See, e. g., H. R. 11, 102d Cong., 2d Sess., § 4501 (1992) (as returned from conference, Oct. 5, 1992) (proposing amortization of purchased goodwill and certain other intangible assets over a 14-year period); H. R. 4210, 102d Cong., 2d Sess., § 4501 (1992) (as returned from conference, Mar. 20, 1992) (same); H. R. 3040, 102d Cong., 2d Sess., § 302 (1992) (as returned from the Committee on Finance, June 19, 1992) (16-year period); H. R. 3035, 102d Cong., 1st Sess., § 1 (1991) (as introduced, July 25, 1991) (14-year period); see also H. Res. 292, 102d Cong., 1st Sess. (1991) (adopted Nov. 26, 1991, 137 Cong. Rec. H11317-H11318) (concerning the effective date of "any legislation enacted with respect to amortization of goodwill").

----------End Footnotes---------- [*60]

III

Because the Court of Appeals correctly reversed on the basis that Newark Morning Ledger failed to demonstrate that the asset it sought to depreciate was not goodwill, which is nondepreciable as a matter of law, see 945 F.2d at 568, I would affirm the judgment below. From the Court's holding to the contrary, I respectfully dissent.