INTERNAL REVENUE CODE

SECTION 197

THE EFFECT ON THE SMALL BUSINESS OWNER

by Donald L. Lader Jr.

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I. Introduction

Intangible assets are commonly defined as "the value of a firm in excess of the value of tangible assets."[1] Over 150 categories of intangible assets have been identified.[2] During the 1980s, the value and importance of intangible assets grew from about $45 billion in 1980 to $262 billion in 1987.[3] During this same time period, the country saw a large number of acquisitions, with large premiums being paid by the acquiring corporations. These premiums were usually attributed to intangible assets. This classification usually led to litigation with the Internal Revenue Service (the Service) concerning the amortization of these intangible assets. The question of an allowable amortization of an intangible assets has been the subject of controversy between the Service and taxpayers for many years.[4] The two areas of concern had been that of goodwill and that of proving an intangible asset was distinct from goodwill and had a definite useful life.

Since the 1920s, the courts have recognized goodwill as an intangible asset but with an indefinite and indeterminable life.[5] In 1918, the Eighth Circuit Court of Appeals held that: (1) goodwill had no existence separate and apart from an established business; (2) goodwill was expressly different from patents and copyrights, which could be sold; and (3) absent specific statutory direction, goodwill could not be amortized under the Revenue Act of 1918.[6] Shortly after this decision, the IRS issued Treasury Decision 4055, which stated, "In view of the decision of the [Eighth Circuit in Red Wing], Article ... 163 of the Regulations [is] hereby amended by the addition thereto of the provision that: 'No deduction for depreciation, including obsolescence, is allowable in respect of goodwill'".[7]

The second issue was last addressed by the United States Supreme Court with its decision in Newark Morning Ledger Co. v. United States.[8] The Court rejected the 'mass asset' rule the Service had long relied on to defeat claims by business of a clearly defined, limited life intangible asset.[9] The Court made it clear that non-goodwill intangible assets could be amortized as long as the taxpayer could bear its two-pronged burden of proof.[10]

This country has seen a move toward a service based economy. American industry is becoming more service and information oriented as technological capabilities grow. Intangible assets now make up a substantial portion of the U.S. economy.[11] On August 6, 1993, Congress passed the Omnibus Budget Reconciliation Act after a two year debate.[12] For the first time since 1927, taxpayers can now amortize all intangible assets, including goodwill.[13] The goal of Congress was to end the seemingly constant litigation between the Service and taxpayers.[14] Only time will determine if this goal has been successfully reached.

This paper will provide a discussion of Section 197 of the Omnibus Budget Reconciliation Act of 1993 and its potential effects on a small business with limited tangible assets but either acquiring or creating substantial intangible assets. The conclusion will argue that such a business should support the current interpretation of Section 197 with a need for strong input to the drafting of anti-churning rules. These rules are currently in the drafting stage by the Service. This paper will not address the concerns of large corporations although many of the concerns may be shared.

II. Brief History of Section 197

In 1909, "[C]ongress recognized that a corporation should calculate its annual net income by deducting from gross income all losses actually sustained within the year . . . including a reasonable allowance for depreciation of property, if any."[15] Thus was born the depreciation deduction as codified in Section 167 of the Internal Revenue Code. under the 1918 Act.[16] The regulations also recognized that "[i]ntangibles . . . may be the subject of a depreciation allowance."[17] In 1927, the Treasury, in response to litigation concerning the allowance of loss of goodwill by distillers,[18] issued a regulation disallowing depreciation of good will.[19] This position was maintained until the enactment of Section 197.[20]

Treasury Regulation section 1.167(a)-3 provided another method of possibly acquiring an amortization right for intangible assets.[21] If a taxpayer could successfully meet its burden of establishing a useful life that would distinguish an intangible asset from goodwill, amortization would be allowed. . This burden

was usually not able to be met and the Service would classify the intangible as goodwill and not allow amortization.[22] In those cases where the Service would agree that an intangible could be amortized, they would argue that the value of the intangible is estimated to high by the taxpayer.[23] If the Service did not win the valuation argument, they would then attack the useful life determination the taxpayer would propose.[24] In most cases, the Service would win.[25]

To bolster their defense against taxpayer attacks on the amortization issue, the Service developed the tactic of implementing the mass asset rule. This rule was perhaps best defined in Golden State Towel & Linen Service v. United States.[26] Under the mass asset rule, "Certain intangible properties are nondepreciable as a matter of law because such intangible properties are part of a single mass asset which in the aggregate has no determinable useful life and is either 'inextricably linked' to goodwill or 'self-regenerating.'"[27] Thus, even if a taxpayer could convincingly argue that an intangible asset was separate from goodwill, its "self-regenerating" nature would prevent it from amortization. The Service was able to limit the amortization in this manner until 1973.

In 1973, the case of Houston Chronicle Publishing Co. v. United States started the downfall of the Service's reign over intangible assets.[28] The Fifth Circuit found that the cost of a subscription list for a newspaper could be amortized over its useful life if it met a two-pronged standard; (1) the lists must have an ascertainable value separate and distinct from goodwill, and (2) they must have a limited useful life, the duration of which can be ascertained with reasonable accuracy.[29]

The Fifth Circuit also found that the taxpayer had a right to prove ascertainable value and limited useful life.[30] In addition, it rejected "the establishment of a per se rule and a monolithic 'mass asset' theory that would amalgamate all subscriptions lists with goodwill . . . . All that the law and regulations require is reasonable accuracy in forecasting the asset's useful life."[31] The Eighth Circuit came to same basic conclusion in Donrey, Inc. v. United States.[32] The burden of proving the status of the intangible asset still remained with the taxpayer however.[33]

It was not until the United States Supreme Court decided Newark Morning Ledger that the mass asset rule was finally laid to rest.[34] This case involved an attempt to amortize a "paid subscriber" list acquired during a merger. The Service rejected the amortization attempt.[35] The District Court ruled in Newark's favor, only to be reversed by the Court of Appeals for the Third Circuit.[36] Finally, on April 20, 1993, the United States Supreme Court held that the Newark Morning Ledger Co. could depreciate a $67.8 million intangible asset consisting of "paid subscribers."[37]

The decision in Newark Morning Ledger had finally presented a road map the taxpayer could follow to win an intangible case against the Service. It was a 5-4 decision, leading to the question of whether the United States Supreme Court would rule the same way with a different intangible asset. That question, however, was put to rest on August 10, 1993 with the enactment of Section 197.[38]

By July, 1991, Representative Dan Rostenkowski, (D-Ill.), chairman of the House Ways & Means Committee, decided to take action on the ongoing disputes concerning intangible assets. He introduce H.R. 3035 as an attempt to once and for all settle the disagreements between the Service, the Courts and the taxpayers.[39] This bill clearly defines a "qualified asset" for all parties concerned.[40] In addition, all qualified assets are to be amortized over a 15 year period.[41] The original bill was not adopted as presented, however, the final version from the Conference Agreement was able to achieve the purpose Representative Rostenkowski set out to achieve.[42]

III. Section 197 of the Internal Revenue Code.

As described in the Internal Revenue Code ("I.R.C."), Section 197 addresses only those qualified intangibles that are acquired at the time business is purchased.[43] There is a further requirement that the intangibles be acquired after the enactment of Section 197 and the assets must be "held in connection with the conduct of a trade or business."[44] Intangibles acquired separately after the business is acquired also qualify for amortization.[45]

Section 197 does provide some specific guidance to some intangibles that will not qualify as Section 197 intangibles.[46] These non Section 197 intangibles are further clarified in the Congressional Record as follows:

(1) Interests in a corporation, partnership, trust of estate: The term "section 197 intangible" does not include any interest in a corporation, partnership, trust, or estate. Thus, for example, the bill does not apply to the cost of acquiring stock, partnership interests, or Interests in a trust or estate, whether or not such interests are regularly traded on an established market.

(2) Interests under certain financial contracts: The term "section 197 intangible" does not include any interest under an existing futures contract, foreign currency contract, notional principal contract, interests rate swap, or other similar financial contract, whether or not such interest is regularly traded on an established market. Any interest under a mortgage servicing contract, credit care servicing contract or other contract to service indebtedness issued by another person, and any interest under an assumption reinsurance contract is not excluded from the definition of the term " section 197 intangible" by reason of the exception for interest under certain financial contracts.

(3) Interests in land: The term "section 197 intangible" does not include any interest in land. Thus, the cost of acquiring an interest in land is to be taken into account under present law rather than under the bill. For this purpose, an interest in land includes a fee interest, life estate, remainder, easement, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning, variances, and any other similar rights with respect to land. An interest in land is not to include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television services. The costs of acquiring licenses, permits and other rights relating to improvements to land, such as building construction or use permits, are amortized over the life of the improvement in accordance with present law.

(4) Certain computer software: The term "section 197 intangible" does not include computer software (whether acquired as part of a trade or business or otherwise) that (1) is readily available for purchase by

the general public; (2) is subject to a non-exclusive license; and (3) has not been substantially modified. In addition, the term "section 197 intangible" does not include computer software which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

For purposes of the bill, the term "computer software" is defined as any program (i.e., any sequence of machine-readable code) that is designed to cause a computer to perform a desired function. The term "computer software" includes any incidental and ancillary rights with respect to computer software that (1) are necessary to effect the legal acquisition of the title to, and the ownership of, the computer software, and (2) are used only in connection with the computer software. The term "computer software" does not include any data base or similar item (other than a data base or item that is in the public domain and that is incidental to the software) regardless of the form in which it is maintained or stored.

If a depreciation deduction is allowed with respect to any computer software that is not a section 197 intangible solely by reason of the exceptions described in the preceding paragraph, the amount of the deduction is to be determined by amortizing the adjusted basis of the computer software ratably over a 36-month period that begins with the month that the computer software is placed in service. For this purpose, the cost of any computer software that is taken into account as part of the cost of computer hardware or other tangible property under present law is to continue to be taken into account in such manner under the bill. In addition, the cost of any computer software that is currently deductible (i.e., not capitalized) under present law is to continue to be taken into account in such manner under the bill.

(5) Certain interests in films, sound recordings, video tapes, books, or other similar property: The term "section 197 intangible" does not include any interest (including an interest as a licensee) in a film, sound recording, video tape, book, or other similar property (including the right to broadcast or transmit a live event) if the interest is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

(6) Certain rights to receive tangible property or services: The term "section 197 intangible" does not include any right to receive tangible property or services under a contract (or any right to receive tangible property or services granted by a governmental unit or an agency or instrumentality thereof) if the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to a right to receive tangible property or services that is not a section 197 intangible, the amount of the deduction is to be determined in accordance with regulations to be promulgated by the Treasury Department. It is anticipated that the regulations may provide that in the case of an amortizable right to receive tangible property or services in substantially equal amounts over a fixed period that is not renewable, the cost of acquiring the right will be taken into account ratably over such fixed period. It is also anticipated that the regulations may provide that in the case of a right to receive a fixed amount of tangible property or services over an unspecified period, the cost of acquiring such right will be taken into account under a method that allows a deduction based on the amount of tangible property or services received during a taxable year compared to the total amount of tangible property or services to be received.

For example, assume that a taxpayer acquires from another person a favorable contract right of such person to receive a specified amount of raw materials each month for the next three years (which is the remaining life of the contract) and that the right to receive such raw materials is not acquired as part of the acquisition of assets that constitute a trade or business or a substantial portion thereof (i.e., such contract right is not a section 197 intangible). It is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract. Alternatively, if the favorable contract right is to receive a specified amount of raw materials during an unspecified period, it is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right by multiplying such cost by a fraction, the numerator of which

is the amount of raw materials received under the contract during any taxable year and the denominator of which is the total amount of raw materials to be received under the contract.

It is also anticipated that the regulations may require a taxpayer under appropriate circumstances to amortize the cost of acquiring a renewable right to receive tangible property or services over a period that includes all renewal options exercisable by the taxpayer at less than fair market value.

(7) Certain interests in patents or copyrights: The term "section 197 tangible" does not include any interest in a patent or copyright which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to an interest in a patent or copyright and the interest is not a section 197 intangible, then the amount of the deduction is to be determined in accordance with regulations to be promulgated by the Treasury Department. It is expected that the regulations may provide that if the purchase price of a patent is payable on an annual basis as a fixed percentage of the revenue derived from the use of the patent, then the amount of the depreciation deduction allowed for any taxable year with respect to the patent equals the amount of the royalty paid or incurred during such year.

(8) Interests under leases of tangible property: The term "section 197 intangible" does not include any interest as a lessor or lessee under an existing lease of tangible property (whether real or personal). The cost of acquiring an interest as a lessor under a lease of tangible property where the interest as lessor is acquired in connection with the acquisition of the tangible property is to be taken into account as part of the cost of the tangible property. For example, if a taxpayer acquires a shopping center that is leased to tenants operating retail stores, the portion (if any) of the purchase price of the shopping center that is attributable to the favorable attributes of the leases is to be taken into account as a part of the basis of the shopping center and is to be taken into account in determining the depreciation deduction allowed with respect to the shopping center.

The cost of acquiring an interest as a lessee under an existing lease of tangible property is to be taken into account under present law (see section 178 of the Code and Treas. Reg. sec. 1.162-11(a)) rather than under the provisions of the bill. In the case of any interest as a lessee under a lease of tangible property that is acquired with any other intangible property (either in the same transaction or series of related transactions), however, the portion of the total purchase price that is allocable to the interest as a lessee is not to exceed the excess of (1) the present value of the fair market value rent for the use of the tangible property for the term of the lease, over (2) the present value of the rent reasonably expected to be paid for the use of the tangible property for the term of the lease.

(9) Interests under indebtedness: The term "section 197 intangible" does not include any interest (whether as a creditor or debtor) under any indebtedness that was in existence on the date that the interest was acquired. Thus, for example, the value of assuming an existing indebtedness with a below-market interest rate is to be taken into account under present law rather than under the bill. In addition, the premium paid for acquiring the right to receive an above-market rate of interest under a debt instrument may be taken into account under section 171 of the Code, which generally allows the amount of the premium to be amortized on a yield-to-maturity basis over the remaining term of the debt instrument. This exception for interests under existing indebtedness does not apply to the deposit base and other similar items of a financial institution.

(10) Professional sports franchises: The term "section 197 intangible" does not include a franchise to engage in professional baseball, basketball, football, or other professional sport, and any item acquired in connection with such a franchise. Consequently, the cost of acquiring a professional sports franchise and related assets (including any good will, going concern value, or other section 197 intangibles) is to be allocated among the assets acquired as provided under present law (see, for example, section 1056 of the Code) and is to be taken into account under the provisions of present law.

(11) Purchased mortgage servicing rights: The term "section 197 intangible" does not include any right to service indebtedness that is secured by residential real property (a "purchased mortgage servicing right"), unless such right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than such right or other such purchased mortgage servicing rights) constituting a trade or business or a substantial portion of a trade or business.

(12) Regulatory authority regarding rights of fixed term or duration: The bill authorizes the Treasury Department to issue regulations that exclude a right received under a contract, or granted by a governmental unit or an agency or instrumentality thereof, from the definition of a section 197 intangible if (1) the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business (or a substantial portion thereof) and (2) the right either (A) has a fixed duration of less than 16 years or (B) is fixed as to amount and property amortizable (without regard to this provision) under a method similar to the unit of production method. Generally, it is anticipated that the mere fact that a taxpayer will have the opportunity to renew a contract or other right on the same terms as are available to others, in a competitive auction or similar process that is designed to reflect fair market value and in which the taxpayer is not contractually advantaged, will not be taken into account in determining the duration of such right or whether it is for a fixed amount. However, the mere facts that competitive bidding occurs at the time of renewal and that there are or may be modifications in price (or in terms or requirements relating to the right that increase the cost to the bidder) shall not be within the scope of the preceding sentence unless the bidding also actually produces a fair market value price comparable to the price that would obtain if the rights were purchased in an arm's length transaction. Furthermore, it is expected that, as under present law, the Treasury Department will take into account all the facts and circumstances, including any facts indicating an actual practice of renewals or expectancy of renewals.

For example, Company A enters into a license with Company B to use certain know-how developed by B. The license is for five years and provides that it cannot be renewed by A except on terms that are fully

available to A's competitors and will reflect an arm's length price determined at the time of renewal. The license does not constitute a substantial portion of a trade or business and is not entered into as part of a transaction (or series of related transactions) that constitute the acquisitions of a trade or business or substantial portion thereof. It is anticipated that in these circumstances the regulations will provide that the license is not a section 197 intangible because it is of fixed duration of less than 15 years.

The regulations may also prescribe rules governing the extent to which renewal options and similar items will be taken into account for the purpose of determining whether rights are fixed in duration or amount. It is also anticipated that such regulations may prescribe the appropriate method of amortizing the capitalized costs of rights which are excluded by such regulations from the definition of a section 197 intangible.

(13) Exception for certain self-created intangibles: The bill generally does not apply to any section 197 intangible that is created by the taxpayer if the section 197 intangible is not created in connection with a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion thereof.

For purposes of this exception, a section 197 intangible that is owned by a taxpayer is to be considered created by the taxpayer if the intangible is produced for the taxpayer by another person under a contract with the taxpayer that is entered into prior to the production of the intangible. For example, a technological process or other know-how that is developed specifically for a taxpayer under an arrangement with another person pursuant to which the taxpayer retains all rights to the process or know-how is to be considered created by the taxpayer.

The exception for "self-created" intangibles does not apply to the entering into (or renewal of) a contract for the use of a section 197 intangible. Thus, for example, the exception does not apply to the capitalized costs incurred by a licensee in connection with the entering into (or renewal of) a contract for the use of

know-how or other section 197 intangible. These capitalized costs are to be amortized over the 16-year period specified in the bill.

In addition, the exception for "self-created" intangibles does not apply to: (1) any license, permit, or other right that is granted by a governmental unit or an agency or instrumentality thereof; (2) any covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (3) any franchise, trademark, or trade name. Thus, for example, the capitalized costs incurred in connection with the development or registration of a trademark or trade name are to be amortized over the 16-year period specified in the bill. [47]

Also excluded are those intangibles acquired by the taxpayer if "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," unless gain is recognized and a tax is paid.[48] This provision is commonly known as the anti-churning rule and was designed to prevent the taxpayer from artificially creating a qualified Section 197 intangible asset.[49] These rules are fully described in the Congressional Record as follows:

Special rules are provided by the bill to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill applies.

Under these "anti-churning" rules, goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill may not be amortized as an amortizable section 197 intangible if: (1) the section 197 intangible is acquired by a taxpayer after the date of enactment of the bill; and (2) either (a) the taxpayer or a related person held or used the intangible at any time during the period that begins July 25, 1991, and that ends on the date of enactment of the bill; (b) the taxpayer acquired the intangible from a person that held such intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of

the bill and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill. The anti-churning rules, however, do not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a) (relating to property acquired from a decedent).

For purposes of the anti-churning rules, a person is related to another person if: (1) the person bears a relationship to that person which would be specified in section 267(b)(1) or 707(b)(1) of the Code if those sections were amended by substituting 20 percent for 50 percent; or (2) the persons are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code). A person is treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

In addition, in determining whether the anti-churning rules apply with respect to any increase in the basis of partnership property under section 732, 734, or 743 of the Code, the determinations are to be made at the partner level and each partner is to be treated as having owned or used the partner's proportionate share of the partnership property. Thus, for example, the anti- churning rules do not apply to any increase in the basis of partnership property that occurs upon the acquisition of an interest in a partnership that has made a section 754 election if the person acquiring the partnership interest is not related to the person selling the partnership interest. These "anti-churning" rules are not to apply to any section 197 intangible that is acquired from a person with less than a 50-percent relationship to the acquirer to the extent that: (1) the seller recognizes gain on the transaction with respect to such intangible; and (2) the seller agrees, notwithstanding any other provision of the Code, to pay a tax on such gain which, when added to any other Federal income tax imposed on such gain, equals the product of such gain and the highest rate of tax imposed by section 1 or 11 of the Code, whichever is applicable. The seller is treated as satisfying the sec-

ond requirement if the excess of (1) the total tax liability for the year of the transaction over (2) what its tax liability for such year would have been had the sale of the intangible (but not the remainder of the transaction) been excluded from the computation equals or exceeds the product of the gain on that asset times the relevant maximum rate.[50]

The I.R.C. does provide a definitive list of what will qualify as an intangible asset for which amortization will be allowed. Ten broad categories, known as "Section 197 intangibles," were enumerated and explained within the bills and committee discussions in Congress. The following explanation of each category provides a good insight into the intent of Congress in determining each.

(1) Goodwill and going concern value: For purposes of the bill, goodwill is the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor.

In addition, for purposes of the bill, going concern value is the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern. Going concern value includes the value that is attributable to the ability of a trade or business to continue to function and generate income without interruption notwithstanding a change in ownership. Going concern value also includes the value that is attributable to the use or availability of an acquired trade or business (for example, the net earnings that otherwise would not be received during any period were the acquired trade or business not available or operational). Workforce, information base, know-how, customer-based intangibles, supplier-based intangibles and other similar items.

(2) Workforce: The term "section 197 intangible" includes workforce in place (which is sometimes referred to as agency force or assembled workforce), the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence

of a highly-skilled workforce is to be amortized over the 15-year period specified in the bill. As a further example, the cost of acquiring an existing employment contract (of contracts) or a relationship with employees or consultants (including but not limited to any "key employee" contract or relationship) as part of the acquisition of a trade or business is to be amortized over the 15- year period specified in the bill.

(3) Information base: The term "section 197 intangible" includes business books and records, operating systems, and any other information base including lists or other information with respect to current or prospective customers (regardless of the method of recording such information). Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems is to be amortized over the 15-year period specified in the bill. As a further example, the cost of acquiring customer lists, subscription lists, insurance expirations, patient or client files, or lists of newspaper, magazine, radio or television advertisers is to be amortized over the 15-year period specified in the bill.

(4) Know-how: The term "section 197 intangible" includes any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. For this purpose, the term "section 197 intangible" is to include package designs, computer software, and any interest in a film, sound recording, video tape, book, or other similar property, except as specifically provided otherwise in the bill.

(5) Customer-based intangibles: The term "section 197 intangible" includes any customer-based intangible, which is defined as the composition of market, market share, and any other value resulting from the future provision of goods or services pursuant to relationships with customers (contractual or otherwise) in the ordinary course of business. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of customer base, circulation base, undeveloped market or market growth, insurance in force, mortgage servicing contracts, investment management contracts, or other relationships with customers that involve the future provision of goods or services, is to be

amortized over the 15-year period specified in the bill. On the other hand, the portion (if any) of the purchase price of an acquired trade or business that is attributable to accounts receivable or other similar rights to income for those goods or services that have been provided to customers prior to the acquisition of trade or business is not to be taken into account under the bill. In addition, the bill specifically provides that the term "customer- based intangible" includes the deposit base and any similar asset of a financial institution. Thus, for example, the portion (if any) of the purchase price of an acquired financial institution that is attributable to the checking accounts, savings accounts, escrow accounts and other similar items of the financial institution is to be amortized over the 15-year period specified in the bill.

(6) Supplier-based intangibles: The term "section 197 intangible" includes any supplier-based intangible, which is defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a favorable relationship with persons that provide distribution services (for example, favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts, is to be amortized over the 15-year period specified in the bill.

(7) Other similar items: The term "section 197 intangible" also includes any other intangible property that is similar to workforce, information base, know-how, customer-based intangibles, or supplier-based intangibles.

(8) Licenses, permits, and other rights granted by governmental units: The term "section 197 intangible" also includes any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof (even if the right is granted for an indefinite period or the right is reasonably expected to be renewed for an indefinite period). Thus, for example, the capitalized cost of acquiring from any person a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (which is sometimes

referred to as a slot), a regulated airline route, or a television or radio broadcasting license is to be amortized over the 15-year period specified in the bill. For purposes of the bill, the issuance or renewal of a license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof is to be considered an acquisition of such license, permit, or other right.

(9) Covenants not to compete and other similar arrangements: The term "section 197 intangible" also includes any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete; hereafter "other similar arrangement") entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof). For this purpose, an interest in a trade or business includes not only the assets of a trade or business, but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business.

Any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof) is chargeable to capital account and is to be amortized ratably over the 15-year period specified in the bill. In addition, any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) after the taxable year in which the covenant (or other similar arrangement) was entered into is to be amortized ratably over the remaining months in the 15-year amortization period that applies to the covenant (or other similar arrangement) as of the beginning of the month that the amount is paid or incurred.

For purposes of this provision, an arrangement that requires the former owner of an interest in a trade or business to continue to perform services (or to provide property or the use of property) that benefit the trade or business is considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered (or for the property or use of property actually

provided) by the former owner. As under present law, to the extent that the amount paid or incurred under a covenant not to compete (or other similar arrangement) represents additional consideration for the acquisition of stock in a corporation, such amount is not to be taken into account under this provision but, instead, is to be included as part of the acquirer's basis in the stock.

(10) Franchises, trademarks, and trade names: The term "section 197 intangible" also includes any franchise, trademark, or trade name. For this purpose, the term "franchise" is defined, as under present law, to include any agreement that provides one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area. In addition, as provided under present law, the renewal of a franchise, trademarks, or trade name is to be treated as an acquisition of such franchises, trademark, or trade name. The bill continues the present-law treatment of certain contingent amounts that are paid or incurred on account of the transfer of a franchise, trademark, or trade name. Under these rules, a deduction is allowed for amounts that are contingent on the productivity, use, or disposition of a franchise, trademark, or trade name only if (1) the contingent amounts are paid as part of a series of payments that are payable at least annually throughout the term of the transfer agreement, and (2) the payments are substantially equal in amount or payable under a fixed formula. Any other amount, whether fixed or contingent, that is paid or incurred on account of the transfer of a franchise, trademark, or trade name is chargeable to capital account and is to be amortized ratably over the 15-year period specified in the bill. [51]

Several additional provisions were included in the Congressional Record to provide guidance to the Service for crafting the new rules.[52] While these provisions are important to the practitioner, they are beyond the scope of this paper.

With the statutory identification of Section 197 assets, the Congress had to deal with an official date of enactment. There was an intention to allow the Service to settle those cases already in progress.[53] Three options were provided for all other taxpayers. First, a look back provision was made to allow the taxpayer to apply Section 197 to any intangible acquired after the date of enactment, August 10, 1993.[54]

Second, the taxpayer could elect to apply Section 197 to any intangibles acquired after July 25, 1991. If this election is made, all subsequent taxpayers would need to classify the intangible in the same manner unless another method is approved by the Secretary of the Treasury.[55] Finally, the taxpayer may elect not to apply Section 197 "to any acquisition of property by the taxpayer if 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."[56] The Service has provided temporary rules providing guidance for the taxpayer in determining which election is best under a given set of circumstances.[57]

IV. Section 197 Advantages For The Small Business Owner

There are three main advantages provided to the small business owner that acquires or creates a large number of Section 197 intangibles. They are (1) a known ability to amortize the Section 197 assets, (2) the ability to expense the creation costs of Section 197 intangibles, and (3) to be more attractive to larger companies should a buyout be desired. Each of these will be discussed in turn.

A quick digression is necessary to explain the framework that governs the deduction of capital expenditures as defined by the Service. Section 162(a) of the I.R.C. allows a current deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[58] There has been litigation over what constitutes "ordinary" for the purposes of allowing the deduction.[59] For purposes of this paper, it is not necessary to enter that argument. Section 197 clearly states that self-created Section 197 intangibles are to be expensed rather than amortized.[60]

Capital expenditures are defined as "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate ... or any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."[61] Under I.R.C. Section 263(a), deductions for capital expenditures are not allowed.[62]

Section 167 and 168 of the I.R.C. state how tangible and intangible assets involving capital expenditures will be treated. These sections require tangible assets to be recovered through depreciation and intangible assets are recovered through amortization.[63] The deductions are taken over the useful life of the assets since this is when the asset is actually producing income for the company.[64] The I.R.C. provides tables to determine the useful life of tangible assets and Section 197, as enacted, provides a useful life of 15-years for Section 197 intangibles.[65]

With the enactment of Section 197 which defines goodwill as an intangible asset subject to amortization, the Service is able to eliminate the majority of disputes in this area.[66] There is no longer any need to expend time and money in an attempt to allocate a qualified intangible asset away from goodwill. Section 197 has reduced this incentive to attempt to expense many intangible since most are now allowed to be expensed over a 15-year period.[67]

For the small business owner acquiring Section 197 intangibles, this allowance is important. No longer will there be a need to base a decision to buy such intangibles with a concern of litigation costs with the Service. This was noted best by the Committee on Taxation of Corporations of the Association of the Bar of the City of New York as follows:

[W]e believe [section 197] will (i) promote equal treatment of similarly situated taxpayers by clarifying an area of the tax law that heretofore has rewarded sophisticated tax planning and, inappropriately aggressive tax positions taken by some taxpayers; (ii) enable taxpayers to plan and structure acquisitive transactions with a higher level of certainty as to the tax result; and (iii) substantially eliminate any future waste of resources involved in controversies and litigation over amortization of purchased intangibles.[68]

In addition, the small business owner will now be able to increase their bottom line income on an annual basis over the life of the intangible asset.[69] This increase may allow the company to present themselves in a better situation for the purposes of acquiring additional capital. Before Section 197, a high technology company was not able to effectively utilize their Section 197 assets for any financial use since

all these assets were normally classified as nonamortizable goodwill. For a small business with a large quantity of acquired Section 197 intangibles, the tax relief gained by the amortization of Section 197 intangibles may be the difference of growing or closing.[70]

The second main advantage to the small business owner is the ability to expense the cost of creating a Section 197 intangible. Section 197 has made it clear that self-created Section 197 intangibles are not to be amortized over a 15-year period.[71] As long as the criteria of I.R.C. section 263(a) are met, the cost of creation should be allowed as a deduction.[72] Of course, the burden will still be on the taxpayer to show that the requirement of "ordinary" has been met.[73]

These deductions, if allowed, will provide an immediate source of income for the small business. The annual cost will be taken as an expense. This will have the effect of reducing the amount of taxes the business will have to pay, thus creating an income source.[74] Of course, the business will need to have the capital necessary to pay for the creation costs in advance. That source of income may be found either by financing or through the acquisition of Section 197 intangibles as described above.[75]

It is important to note that not all self-created Section 197 intangibles will need to be expensed in the current year. They may in fact be subject to the 15-year amortization rule. Section 197 provides an exception that would allow this to take place.[76] The exception provides that the requirement to expense does not apply to:

(1) any license, permit, or other right that is granted by a governmental unit or an agency or instrumentality thereof;

(2) any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and

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

Thus, for example, the cost of obtaining a license from the government (other than a license of indefinite duration) or the cost of obtaining a franchise from the franchiser is to be amortized over the 15-year period specified in the bill.[77] In these cases, the self-created asset would be treated on the books as a Section 197 intangible with the effects noted earlier.[78]

The final, and perhaps the most important advantage for the small business owner, is the enhanced marketability of the business to others. This advantage assumes that a goal of the small business owner is to be acquired by a larger company or corporation. Since goodwill is now clearly a Section 197 intangible that can be amortized,[79] an acquiring company will be able to eventually expense the cost of acquisition the exceeds the cost of the actual tangible assets of the company. At the same time, if the small business has created Section 197 intangibles, they will now have an identified basis for which they can be amortized.[80]

This ability to possibly amortize or depreciate the entire purchase price of a small business with a high percentage of intangibles much more attractive to acquiring corporations.[81] It has been suggested that "taxable asset acquisitions . . . will become the route of choice to acquire tangible or intangible assets."[82] During the period before the enactment of Section 197, commentators saw promise for just this result. A New York Times article noted that, "Wall Street lobbied hard for Mr. Rostenkowski's proposal because it would make big corporate takeovers and spin-offs of subsidiaries at least slightly more attractive."[83]

With the knowledge that it is easier to sell a small business involved with Section 197 intangibles, banks and other investors may be more willing to invest in the start-up company. They will no longer fear the high costs that were historically associated with these intangibles and the usual litigation with the Service. This may be seen as a less risky adventure with a corresponding increase in potential gain from the acquired or self created Section 197 intangibles. The amount of risk seen however, may be tied to a determination by the investor as to the validity of the argument that intangibles do or do not lose value over time.

With the enactment of Section 197 came the definitive recognition by Congress that intangible assets lose value over time. This recognition was at odds with the Service which had historically taken the position known as the "mass asset rule."[84] The debate as to whether intangible assets waste over time has gone on for many years.[85] It was noted that even "generally accepted accounting principles [GAAP] developed by the Financial Accounting Standards Board (FASB) [have long recognized] that the values of all intangible assets decrease, or waste, over time."[86] Since many managers, creditors and shareholders look to the GAAP produced balance sheets to gauge the health of a company, this position should have a positive effect on any investment decision to finance a small business involved with Section 197 intangibles.

V. Section 197 Disadvantages For The Small Business

There are three main disadvantages to the small business owner from the enactment of Section 197. They are (1) a self created Section 197 intangible asset may not be reflected at its true value, (2) the true value of a company may be largely understated if the company has a large number of self created Section 197 intangibles, and (3) due to an under valuation of self created Section 197 intangibles, the company may become a likely target for a hostile takeover, enhanced by a need for more liquid assets. These areas will be discussed in turn.

As noted in the last section, the cost of creating intangible assets are immediately expensed.[87] While this may appear to be an advantage initially, it can actually be a disadvantage. In order to take advantage of expensing the costs, the costs must be ascertained. With an intangible, this may be both difficult and in itself costly. In the case of goodwill, commentators have focused on advertising to discuss this issue.[88] The argument from the advertising industry is that money spent on advertising only creates short term revenue.[89] The actual tax treatment for advertising expenditures does not always follow this conven-

tion.[90] In any case, the arguments fail to take into consideration the effect of advertising on intellectual property intangibles such as trademarks.

Trademarks are clearly Section 197 intangibles.[91] A trademark has little or no value when it is first created. Over time, the trademark gains recognition with the general public. As this recognition grows, the value of the trademark grows. One way to gain recognition of the trademark is through advertising.[92] Indeed, one requirement for a Federally recognized trademark be that it is used in commerce.[93] Failure to do so may cause the loss of the trademark.[94] It can be argued that the amount expended on advertising containing the trademark only maintains its value for any given year. This argument, however, fails to explain how the value of the trademark can become greater than the cost of the advertising.

This is a clear example of the first disadvantage of Section 197 to the small business. It can be assumed that one goal of any business is to grow. With this growth will eventually come some market recognition. Consumers will come to recognize the company either by name or some other identifying mark. The cost of creating this Section 197 intangible, either as goodwill or a trademark, may actually be very low. For a local company or a specialized company, the advertising may consist mostly of word-of-mouth. These costs cannot be capitalized nor deducted. The end result for the small business owner is a loss of possible income.

Even with current computer based accounting systems, it is nearly impossible to determine the costs and benefits of this type of activity.[95] Without the ability to ascertain the costs it is impossible to place a current deduction on the books. This causes the business to lose the tax advantage it would normally have seen.[96] Since the Section 197 intangible is self created, it cannot be capitalized.[97] This results in the loss of the tax advantage the would normally be seen for the amortization of a Section 197 intangible.[98] This inability to place these items on the company books results in an inaccurate valuation of the company. Indeed, it is possible the most valuable asset of the company may be the trademark it generated

over time at minimal cost. This may lead to a loss of financing, a critical element of small business success. This is the second disadvantage of Section 197 for the small business.

The situation created by the first two disadvantages of Section 197 create the most troublesome disadvantage of Section 197. That final disadvantage is of a potential hostile takeover. The small business may find itself in the position of being truly undervalued in the are of Section 197 intangibles. Upon acquisition by another company, the locked out value of the Section 197 intangibles described earlier can be realized since Section 197 clearly allows for the recognition of these intangibles upon the acquisition of a business.[99] As noted above, this position is desirable if a business desires a buyout. It is however, a disadvantage for the business that does not desire such a buyout.

One area of Section 197 that causes some concern is difficult to classify as either an advantage or disadvantage. That area is the set amortization period of 15 years assigned to all Section 197 intangibles.[100] While this may be advantageous for those assets that clearly have a life greater than 15 years, it is a clear disadvantage for those assets with a shorter life. One such agreement is a covenant-not-to-compete.[101] In these cases, the business owner is actually receiving a smaller benefit that could have been realized.[102] It will simply take 15 years to recover the costs of a three year asset. Some practitioners believe that the 15 year period is a fair trade for the ability to even amortize the intangible to begin with.[103] Surely this is preferable to the extensive litigation that was the norm before the enactment of Section 197.[104]

From the perspective of Congress, a set amortization period provided the most administratively convenient manner of implementing Section 197. Congress has taken this stance in the past when articulating a bright-line rule in this type of situation where the cost of calculating actual figures is high and the risk that taxpayers may exaggerate costs is high.[105] It has been suggested that the resulting balance between the needs of the service and those of the taxpayer, although not equal, are still in favor of the taxpayer.[106] There is no doubt, however, in this writer's mind that the future will see litigation in this area. Since cor-

porations no longer need to expend funds attempting to get approval to amortize intangibles, some of that money will be used in an attempt to massage the new Section 197 in their favor.[107]

VI. Conclusion

The small business owner is in a position that requires an early decision. That decision must be whether to move forward with an eye toward acquisition or to fight acquisition. The current state of Section 197 requires this determination.

For the small business owner that does not wish to be acquired, efforts should be made to require the capitalization of self generated Section 197 intangibles. This will allow the company to receive the results of their efforts over a long period of time while avoiding the hidden value they have acquired. This will make the company less attractive for a hostile takeover. The full value of the company will be reflected on the books and the acquiring company will gain little from the takeover.

The small business owner will find some support for this position from the Service.[108] If this approach is successful, the small business owner will be protected. Another way to attack the problem is to change the anti-churning rules found in Section 197.[109] If the rules are modified to allow a company that self creates a Section 197 intangible to periodically value that asset, its true value could be added to the books. This procedure would require an adjustment to the basis of the intangible asset. Such basis adjustments are not foreign to the I.R.C. and are envisioned within Section 197.[110] The problem is that posed by the restriction on "related person" transfers[111] and the "anti-abuse" rules.[112] A special exception could be crafted that would restrict the transfer to the same person solely for the purpose of recognizing gain. The transaction could be a tax event, in which case the Service could recoup some of the loss it believes the enactment of Section 197 caused.[113]

If the small business desires a future buyout, then the current status of Section 197 is sufficient. As noted above, daily business operations will eventually create Section 197 intangibles that will not be reflected on the books. This situation will eventually place the company in a position where a buyout will be very profitable to the acquiring company. As long as the initial company can survive with the loss of any potential income as identified above in section V, this is a viable option. Indeed, if the overall goal is a buyout, that plan, in addition to the potential hidden value of self created Section 197 intangibles, may provide the catalyst needed to acquire investment capital for the business.

In either case, the small business owner will now need to pay more attention to Section 197 intangibles. Failure to do so may place them in the position for an unwanted hostile buyout. In the alternative, failure to do so may cause the business to fail to lack of capital when capital could have been acquired. Both of these situations can be avoided by incorporating Section 197 intangibles into the business plan.

[1] Jane G. Gravelle and Jack Taylor, Congressional Research Service Report for Congress, Taxing Intangibles: An Economic Analysis (1991), reprinted in 91 Tax Notes Today 219-31 (Oct. 24, 1991), available in LEXIS, Taxana Library, TNT File.

[2] See infra note 14. The GAO Report analyzed data compiled by the Service in 1989: "[The] IRS identified 2,166 open audit issues in its examination, appeals, and litigation units. These issues included over 150 different types of intangible assets identified and claimed as amortizable by taxpayers."

[3] Id. at 2.

[4] See infa Part II.

[5] Red Wing Malting Co. v. Willcuts, 15 F.2d 626 (8th Cir. 1926), cert. denied, 273 U.S. 763 (1927).

[6] Red Wing, 15 F.2d at 634. The court held that the 1918 Revenue Act - which states that a "reasonable allowance for exhaustion, wear and tear of property used in a trade or business, including a reasonable allowance for obsolescence" -- does not permit the amortization of goodwill. Id.; see Revenue Act 1918, ch. 18, § 634(a)(7), 40 Stat. 1057, 1077 (1917).

[7] T.D. 4055, VI-2 C.B. 63 (1927).

[8] Newark Morning Ledger Co. v. United States, 113 S.Ct. 1670 (1993).

[9] John J. Cross III, Purchase Price Allocations and Amortization of Intangibles, 209 4th Tax Management Portfolio A-25 (1991) (citing Danville Press, 1 B.T.A. 1171 (1925)).

[10] See Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973).

[11] According to a New York Times article:

> Intangibles comprise as much as 40 percent of the value of cable-television franchises, with their big customer lists and entrenched position as the only company of their kind in most towns. The value of a big consumer products company, with popular brand names and a good reputation, could consist of 80 percent intangible assets. A small-town insurance agency is close to 100 percent intangible, with little more than its customers and reputation for service to pass on to a buyer. Michael Wines, The Fine Print: A Periodic Look Behind the Law; Assets Intangible? Congress Has an Idea For You, N.Y. Times, July 15, 1993, at A1, A18.

[12] OBRA passed 218 to 216 in the House and 51-50 in the Senate. N.Y. Times, August 7, 1993, at A1.

[13] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261, 107 Stat. 312 (1993).

[14] United States General Accounting Office, Report to the Joint Committee on Taxation, Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets, GAO/GGD-91-88 (Aug., 1991) reprinted in 91 Tax Notes Today 169-1 (Aug. 13, 1991), available in LEXIS, Taxana Library, TNT file (the "GAO Report").

[15] Newark Morning Ledger, 113 S.Ct. at 1674 (1993), quoting Tariff of 1909, § 38 Second, 36 Stat. 11, 113. The 1909 Act also provided: "Such net income shall be ascertained by deducting from the gross amount of the income . . . (first) all the ordinary and necessary expenses actually paid within the year . . .; (second) all losses actually sustained within the year . . ., including a reasonable allowance for depreciation of property. . . ." Tariff of 1909, 36 Stat. 11, 113 (emphasis added).

[16] 40 Stat. 1057, 1078, § 234(a)(7) (1919).

[17] T.D. 2929, C.B. 1 (1919).

[18] Justice Blackmun, writing for the majority in Newark Morning Ledger noted that "between 1919 and 1927, the IRS recognized that the goodwill of distillers might be depreciable as a result of the passage of the Eighteenth Amendment. . . ." 113 S.Ct. 1670, 1675 n.8. (emphasis added). See also T.B.R. 44, C.B. 1 (1919) (Advisory Tax Board office letter holding that distillers were entitled to deduct loss of goodwill).

[19]In 1927, the Commissioner amended the Treasury Regulations to prohibit the amortization of goodwill. Under this amended regulation, "No deduction for depreciation, including obsolescence, [was] allowable in respect of good will." T.D. 4055, C.B. VI-2 (1927). Despite this regulation, taxpayers were still allowed to amortize other intangibles if the taxpayers could prove the intangible assets were "definitely limited in duration."

[20] Treas. Reg. § 1.167(a)-3 (1960). The regulation provided: "No deduction for depreciation is allowable with regard to goodwill."

[21] Treas. Reg. § 1.167(a)-3 (as amended in 1960). The regulation states:

> If an intangible asset is known from experience or other factors to be of use in the business or 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 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 good will.

[22] The IRS typically argues that the intangible asset in question is simply goodwill, with an indeterminable life; conversely, the taxpayer argues that the asset in question has real value, distinguishable from goodwill, and should therefore be deductible. The General Accounting Office estimates that over 70% of IRS's proposed adjustments were based on classifications of intangible assets as equivalent to nonamortizable goodwill. GAO REPORT, supra note 14, at 30-31; see, e.g., Panichi, Inc. v. United States, 834 F.2d 300 (2d Cir. 1987)(accepting taxpayer's argument that trash collection customer names were separate and distinct from goodwill); Richard S. Miller & Sons, Inc. v. United States, 537 F.2d 446 (Ct. Cl. 1976)(accepting taxpayer's argument that insurance expirations were separate and distinct from goodwill); Houston Chronicle, 481 F.2d at 1240 (accepting taxpayer's argument that subscription lists of newspaper were amortizable intangible assets); AmSouth Bancorporation v. United States, 681 F. Supp. 698 (N.D. Ala. 1988)(rejecting taxpayer's argument that core deposits of bank were separate and distinct from goodwill); General Television, Inc. v. United States, 449 F. Supp. 609 (D. Minn. 1978), aff'd per curiam, 598 F.2d 1148 (8th Cir. 1979)(rejecting taxpayer's argument that cable television subscriber lists were separate and distinct from goodwill); Computing & Software, Inc. v. Commissioner, 64 T.C. 233 (1975)(accepting taxpayer's argument that credit information was separate and distinct from goodwill).

[23] The IRS typically argues that the taxpayer's allocation to the intangible asset is much lower, and that the valuation to goodwill is much higher. The General Accounting Office could not determine the precise percentage of the IRS's proposed adjustments based on overallocation of the purchase price to intangible assets and underallocation to goodwill. GAO REPORT, supra note 14, at 30. The General Accounting Office could estimate, however, that these "valuation" issues, combined with issues related to useful life, accounted for over 30% of IRS's proposed adjustments. See GAO REPORT, supra note 14, at 29-30.

[24] The IRS typically argues that the taxpayer's determination of useful life is much shorter than it should be. 137 CONG. REC. E2706, 2707 (daily ed. July 25, 1991). For example, the intangible asset that generates the greatest amount of controversy is the consumer-or market-based intangible. GAO REPORT, supra note 14, at 22. According to IRS survey data, the taxpayer's average claimed life for these particular intangibles was 9.4 years compared to the IRS's average adjusted life of 10.8 years. GAO REPORT, supra note 14, at 30.

[25] According to one source, there have been 123 litigated intangibles cases. Of the 123, the Service has won 83 (two-thirds). New York State Bar Association Tax Section, Report on Proposed Legislation on Amortization of Intangibles (H.R. 3035), 53 Tax Notes 943, 946 (Nov. 25, 1991).

[26] 373 F.2d 938, 944 (Ct. Cl. 1967).

[27] John J. Cross III, Purchase Price Allocations and Amortization of Intangibles, 209 4th Tax Management Portfolio A-25 (1991) (citing Danville Press, 1 B.T.A. 1171 (1925)).

[28] 481 F.2d 1240 (5th Cir. 1973).
[29] Id. at 1251
[30] Id.
[31] Id. at 1253-54.
[32] 809 F.2d 534 (8th Cir. 1987).
[33] Houston Chronicle, 481 F.2d at 1254; Donrey, Inc., 809 F.2d at 537.
[34] The majority in Newark Morning Ledger read Houston Chronicle and Revenue Ruling 74-456 "as rejecting the mass asset rule." George L. Middleton, Jr. and Christian M. McBurney, The Morning After Newark Morning Ledger: What Should Taxpayers Do Now? 59 Tax Notes 817, 821 (May 10, 1993) (citing Newark Morning Ledger, 61 U.S.L.W. at 4317). The Supreme Court's interpretation of a dead mass asset rule was, according to Middleton and McBurney "[c]onsistent with [the opinion of] most tax practitioners."
[35] Newark Morning Ledger, 113 S.Ct. at 1673.
[36] Id. at 1674 (citing Newark Morning Ledger Co. v. United States, 945 F.2d 555, 567 (1991)).
[37] Newark Morning Ledger, 113 S.Ct. at 1683.
[38] See supra note 13.
[39] H.R. 3035, 102d Cong., 1st Sess. (1991).
[40] 137 CONG. REC. E2707 (daily ed. July 25, 1991). "Qualified" refers to: goodwill; going concern value; work force in place; customer and subscription lists; know-how, including computer software and drawings; customer-based intangibles; supplier-based intangibles; covenants not to compete; and certain franchises, trademarks, patents, copyrights, and tradenames. Id. at E2707 to E2708.

"Qualified" does not refer to: marketable securities; patents or copyrights not acquired in a transaction involving the acquisition of a trade or business; a professional sports franchise; licenses, permits, or other rights of infinite duration granted by a governmental unit or agency thereof. Id. at 2708.
[41] 137 CONG. REC. E2706 (daily ed. July 25, 1991).
[42] The exact language read:

The conferees reiterate the intended purpose of the provision, as stated in both the House and Senate reports, to simplify the law regarding the amortization of intangibles. The severe backlog of cases in audit and litigation is a matter of great concern to the conferees; and any principles established in such cases will no longer have precedential value due to the provision contained in the conference agreement. Therefore, the conferees urge the Internal Revenue Service in the strongest possible terms to expedite the settlement of cases under present law. In considering settlements and establishing procedures for handling existing controversies in an expedited and balanced manner, the conferees strongly encourage the Internal Revenue Service to take into account the principles of the bill so as to produce consistent results for similarly situated taxpayers. Conference Report of the Committee on the Budget House of Representatives to Accompany H.R. 2264, H.R. Conf. Rep. No. 2264, 103d Cong., 1st Sess. 672, 696 (1993) (hereinafter "Conference Report")..
[43] I.R.C. § 197(c)(1).
[44] Id.
[45] Id.
[46] I.R.C. § 197(e).
[47]138 CONG. REC. S11246-01, S11319 - S11321, (adapted to15-year period as enacted).
[48] I.R.C. § 197(f)(9)(i).
[49] Conference Report, supra note 42, at 691.
[50] 138 CONG. REC. S11246-01, S11323 - S11324, (adapted to15-year period as enacted).
[51] 138 CONG. REC. S11246-01, S11317 - S11318, (adapted to15-year period as enacted).
[52] See generally, 138 CONG. REC. S11246-01, (adapted to15-year period as enacted).

[53] See Conference Report, supra note 42, at 696.
[54] 103 Pub. L. No. 66, § 13261(g)(1); I.R.C. § 197(c)(1)(A).
[55]103 Pub. L. No. 66, § 13261(g)(2)(B); During hearings on the bill it was stated:

If a taxpayer makes [the] election [to apply the bill to all property acquired after July 25, 1991], the bill also applies to all property acquired after July 25, 1991 by any taxpayer that is under common control with the electing taxpayer . . . at any time during the period that began on November 22, 1991, and that ends on the date that the election is made. Conference Report, supra note 42 at 691.

[56] 103 Pub. L. No. 66, § 13261(g)(3)(A).
[57] See 26 C.F.R. 1.197-1T.
[58] I.R.C. 162(a). In Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971), the Court divided 162(a) into five separate requirements necessary to qualify for a deduction. To qualify, "an item must (1) be paid or incurred during the taxable year, (2) be for carrying on any trade or business, (3) be an expense, (4) be a necessary expense, and (5) be an ordinary expense." Id. However, Congress has allowed the following exceptions in order to promote policy objectives: deduction of research and experimental expenditures, 174; deduction of soil and water conservation expenditures, 175; deduction of certain depreciable assets, 179; deduction of expenditures by farmers for fertilizer and for clearing land, 180; deduction of expenditures to remove architectural and transportation barriers to the handicapped and elderly, 190; deduction of tertiary injectant expenditures, 193.
[59] Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (citations omitted), ("The principal function of the term "ordinary' in 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in their nature capital expenditures."); see also Southland Royalty Co. v. United States, 582 F.2d 604, 610 (Ct. Cl. 1978) (" "Ordinary,' as used in I.R.C. 162, differentiates between those expenses currently deductible versus those which must be capitalized and amortized over the life of the asset, if they are deductible at all."), cert. denied, 441 U.S. 905 (1979).
[60] I.R.C. § 197(c)(2). See generally the discussion supra on self-created Section 197 assets.
[61] I.R.C. § 263(a).
[62] I.R.C. § 263(a). In addition, I.R.C. 263A sets forth the "uniform capitalization rules," which require the capitalization of all direct and certain indirect costs incurred after December 31, 1986 that are allocable to the production activities of the trade or business and are not the result of inventory which is in the hands of the taxpayer. I.R.C. § 263A .
[63] I.R.C. §§ 167, 168
[64] Id. Accelerated depreciation departs from the general concept that depreciation should match the costs of earning income against the income generated. It provides for a greater deduction during the early years of ownership and a lower deduction in later years, so it is a subsidy to business that encourages greater investment than would otherwise occur.
[65] I.R.C. § 197(a).
[66] GAO REPORT, supra note 14, at 15.
[67] Timothy Gray, IRS Embraces Intangibles Bill's 14-Year Amortization Period, 53 TAX NOTES 511 (1991), Taxpayers might still have an incentive to make "creative adjustments" when allocating purchase price if the allocation would result in a shorter life.
[68] Herbert L. Camp, Retroactive Intangibles Rules Would Be Windfall For Aggressive Taxpayers, Bar Association Says, 57 Tax Notes 477 (October 21, 1992); 92 Tax Notes Today 212-47 (October 26, 1992), available in LEXIS, Taxana Library, TNT File.
[69] A simple example shows the effect of allowing amortization:

Amortization Allowed	Amortizatiion Not Allowed

Income	50,000	50,000
Expenses	15,000	15,000
Amortization	10,000	0
Total Taxable	25,000	35,000
Tax (34%)	8,500	11,900

This reflects a bottom line savings of (11,900 - 8,500) $3,400.

[70] See supra note 69. As shown, the effects of amortization allow the company to keep more of its income, thus providing needed capital for growth, possibly without the need for financing.
[71] See supra note 60.
[72] See supra note 58.
[73] See supra note 59.
[74] A simple example shows this effect:

	Creation Expense Allowed	Creation Expense Not Allowed
Income	50,000	50,000
Normal Expenses	15,000	15,000
Creation Expenses	10,000	0
Total Taxable	25,000	35,000
Tax (34%)	8,500	11,900

This reflects a bottom line savings of (11,900 - 8,500) $3,400.

[75] See supra note 69.
[76] See supra note 60.
[77] 137 CONG. REC. E2706-02, E2709, (adapted to15-year period as enacted).
[78] See supra note 69.
[79] I.R.C. § 197(d)(1)(A).
[80] See supra note 77. "The adjusted basis of a section 197 intangible that is acquired from another person generally is to be determined under the principles of present law that apply to tangible property that is acquired from another person. Thus, for example, if a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible is to be increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount is to amortized over the remaining months in the [15-year] amorticzation period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred. In addition, any expenditure that is directly connected with the protection, registration, or defense of a previously acquired section 197 intangible is not to be taken into account under the bill, but, instead, is to be taken into account under present law.
[81] Reuven S. Avi-Yonah, Newark Morning Ledger: A Post-Litem and Some Implications, 59 Tax Notes 813, 816 (May 10, 1993).
[82] George Brode, Jr., Structuring Taxable Acquisitions of Intangibles under Section 197, 60 Tax Notes 1011, 1024 (August 16, 1993). Evidence offered by Professor Calvin Johnson seems to suggest the playing field is not terribly skewed. According to his sources, from 1986 to 1991, 46% of mergers and acquisitions were cash acquisitions, and 54% were stock acquisitions. Nevertheless, the 46% representing cash acquisitions only accounted for $ 164 billion of the $ 986 billion in merger and acquisition activity during 1986 - 1991 (only 16.6%). This figure leaves $ 822 billion in stock acquisitions. Calvin H. Johnson, The Mass Asset Rule Reflects Income and Amortization Does Not, 56 Tax Notes 629, 630 n.5 (Aug. 3, 1992).

This information must be read carefully. Most practitioners would agree that "General Utilities' repeal made asset purchases uneconomical." Bennett Minton and Lee A. Sheppard, An Intangible Quandary: To Which Taxpayers Go the Spoils? 55 Tax Notes 1568, 1569 (June 22, 1992).

[83] Michael Wines, The Fine Print: A Periodic Look Behind the Law; Assets Intangible? Congress Has an Idea For You, N.Y. Times, July 15, 1993, at A18.

[84] The mass asset rule "treats an asset such as a customer list as one indivisible asset rather than several component parts. The mass asset never really diminishes because, as a component leaves, a new one is added." Annette Nellen and Donald L. Massey, Supreme Court Clarifies Depreciation of Acquired Intangibles, 51 Taxation for Accountants 68, 69 (1993).

[85] Reuven S. Avi-Yonah, Newark Morning Ledger: A Threat to the Amortizability of Acquired Intangibles; Calvin Johnson, The Mass Asset Rule Reflects Income and Amortization Does Not; Avi-Yonah, Getting Out of the 'Silly Quagmire', 57 Tax Notes 427 (Oct. 19, 1992); Johnson, Newark Morning Ledger: Intangibles Are Not Amortizable, 57 Tax Notes 691 (Nov. 2, 1992); Avi-Yonah, Newark Morning Ledger: Striking a Blow for Tax Equity, 57 Tax Notes 819 (Nov. 9, 1992); Johnson, The Argument over Newark Morning Ledger. See also Johnson, Sowing Mass Confusion, 57 Tax Notes 1087 (Nov. 16, 1992); Johnson, The Mass Asset Rule is Not the Blob That Ate Los Angeles, 57 Tax Notes 1603 (Dec. 14, 1992); Johnson, Once More into the Mass Assets, 58 Tax Notes 369 (Jan. 18, 1993); and finally Avi-Yonah, Newark Morning Ledger: A Post-Litem and Some Implications. The above list covers most of the debate.

[86] GAO Report, supra note 14, at 11. See also Colorado Nat'l Bankshares v. Commissioner, 984 F.2d 383 (1993). Judge Kelly noted: "Although not necessarily controlling for income tax purposes, it is certainly pertinent evidence that the . . . FASB, the Securities and Exchange Commissioner, and the Office of the Comptroller of the Currency all require banks to record their core deposits as assets and separate and apart from goodwill." Id. at 385.

[87] See I.R.C. §§ 162, 173, 174 and 263. Section 162(a) provides for deductions of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Treasury Regulation § 1.162-1(a) states, "among the items included in business expenses are . . . advertising and other selling expenses." Section 173(a) states, "notwithstanding section 263, all expenditures . . . to establish, maintain or increase the circulation of a newspaper, magazine or other periodical shall be allowed as a deduction." Similarly, § 174(a)(1) allows taxpayers to deduct for Research and Development expenses incurred during the taxable year. Section 263(c) allows taxpayers to deduct as expenses the intangible costs incurred in drilling for oil and gas.

[88] All companies use advertising to some extent. It can be assumed that the expense of advertising creates goodwill for the company. The taxpayer is allowed to immediately deduct the cost of advertising although the goodwill created may have a positive revenue effect for 15 years.

[89] See Deductibility of Advertising Under Federal Tax Law: Select Revenue Measures Hearing Before the Subcomm. on Revenue of the House Ways and Means Committee, 103d Cong., 1st Sess. (1993) (testimony of Sheldon S. Cohen, Advertising Leadership Council), reprinted in 93 Tax Notes Today 187-63, (Sept. 9, 1993), (arguing that advertising is generally used to produce current revenue.).

[90] Timothy E. Johns, Note, Tax Treatment of the Costs of Internally Developed Intangible Assets, 57 S. Cal. L. Rev. 767, 768 (1984).

[91] I.R.C. § 197(d)(1)(F).

[92] For a good discussion of the economics of trademarks, see Landes & Posner, Trademark Law: An Economic Perspective, XXX, J. L. & Econ. 265, 268-70, 273-75 (1987).

[93] 15 U.S.C. 1501(a).

[94] 15 U.S.C. 1501(d)(4).

[95] See supra note 89.

[96] See supra note 74.

[97] See supra note 60.
[98] See supra note 69.
[99] I.R.C. § 197(c)(1).
[100] I.R.C. § 197(a).
[101] Covenants-not-to-compete have been traditionally amortized over 2-3 years.

[102] A simple example shows this effect:

Assume an asset valued at $15,000. Under a 3 Year schedule, the yearly deduction is $5,000. Under a 15 Year schedule, the yearly deduction is $1,000.

	3 Year Amortization		15 Year Amortization	
Income	50,000		50,000	
Normal Expenses		15,000		15,000
Yearly Amortization	5,000		1,000	
Total Taxable	30,000		34,000	

[103] Jerry L. Oppenheimer, Oppenheimer Calls for Intangibles Legislation, 59 Tax Notes 887 (May 17, 1993); 93 Tax Notes Today 103-36 (May 13, 1993).
[104] Id. Oppenheimer goes on to say "[M]any taxpayers would elect to pay a 'premium' (i.e. elect the longer amortization period) in order to obtain certainty and avoid the onerous legal and accounting fees involved in litigation." Id.
[105] See I.R.C. § 274(n), which generally provides only 80% of meal and entertainment expenses are allowed as a deduction.
[106] A Key Breakthrough on Intangible Assets, Mergers & Acquisitions, Sept. - Oct., 1993, at 9. The mandated 15-year write-off is a two-edged sword. It may penalize companies that have been able to depreciate assets over shorter spans, especially technology firms with products or processes threatened with fast obsolescence. . . . But in the final analysis, allowing both faster and tax-sheltered write-offs for goodwill and going-concern value is the big plus.
[107] How Will The Taxpayer Victory in Newark Morning Ledger Affect Pending Legislation? 78 J. Tax'n 322 (1993). Many taxpayers supported the [intangibles] measure, even though the period was fairly long, as a means of avoiding disputes with the IRS over an intangible's useful life. . . . Now, however, [after Newark Morning Ledger] some taxpayers are betting that they can carry the difficult burden of proof despite the Court's warning, and seem unwilling to trade certainty for a longer recovery period.
[108] The Service stated in its Newark Morning Ledger brief:

Although petitioner has not proposed it, there is an alternative, logically consistent method to account for these expenses. Petitioner could be required to capitalize, rather than deduct currently, all of the current expenses it incurs to maintain and promote its circulation . . . and then be allowed to amortize those expenditures over some appropriately lengthy period of estimated benefit. Marc D. Levy, et al., Supreme Court's Decision on Amortizing Intangibles Removes One Barrier, 79 J. Tax'n 4, 9 (1993) (citing Brief for Respondent at 31).
[109] I.R.C. § 197(f)(9).
[110] I.R.C. § 197(f)(9)(B).

[111] I.R.C. § 197(f)(9)(C).
[112] I.R.C. § 197(f)(9)(F).
[113] George Brode, Jr., Structuring Taxable Acquisitions of Intangibles under Section 197, 60 Tax Notes 1011, 1018 (August 16, 1993). "Approximately $ 8 billion of amortization deductions is under challenge by the Service under prior law. That represents a potential $ 2.7 billion benefit or windfall to taxpayers at a 34% corporate tax rate."