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# INTANGIBLE ASSET DEPRECIATION: *NEWARK* AND SECTION 197

by

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## I. BACKGROUND

### A. Law and Regulations

#### 1. Section 167(a) provides

that 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) held for the production of income.

This provision has been viewed as embracing both tangible and intangible property since the earliest days of the income tax. Over time, however, other provisions such as section 168 (ACRS and MACRS for most tangible property) and 1253 (franchises) have been enacted to provide more specific rules.

2. **Treas. Reg. § 1.167(a)-3** and its predecessors have long provided that an intangible asset may be depreciated if it is "...known from experience or other factors to be of use...for only a limited period of time, the length of which can be estimated with reasonable accuracy". Since 1927, the regulation has forbidden depreciation of goodwill. The 1927 change was made to reflect the Eighth Circuit's decision in *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927) which held that a brewery could not claim depreciation for its loss of goodwill due to prohibition because the loss did not arise from wear, tear or obsolescence.

**Comment:** Intangible assets generally constituted a relatively minor part of the assets of most companies until the 1980s. For those companies included in the Standard and Poor's Compustat database (about 7,000 larger U.S. corporations) intangibles rose from 1.5% in 1971 of total assets to 7% in 1990. Until the 1980's, there was little pressure to clarify the rules for intangibles because the stakes were, relatively speaking, low.

3. **Treas. Reg. § 15A-453-1(c)(6)(ii)** states that "income forecast" basis recovery is available for mineral properties, motion picture films, television

films, taped television shows, and other properties from time to time specified by the Internal Revenue Service. See also Rev. Rul. 60-358, 1960-2 C.B. 68. These properties may be viewed as "tangible" rather than intangible, however.

**B. IRS Rulings and Administrative Pronouncements.** Over the years, the Service has ruled that a number of intangible assets are depreciable; these include:

1. patents, Rev. Rul. 67-136, 1967-1 C.B. 58;
2. player contracts, Rev. Rul. 67-379, 1967-2 C.B. 127;
3. covenants not to compete, Rev. Rul. 68-636, 1968-2 C.B. 92;
4. computer software, Rev. Proc. 69-21, 1969-2 C.B. 303; and
5. package design costs, Rev. Proc. 90-63, 1990-2 C.B. 664.

**C. Case Law**

1. The leading case in the field (before the Supreme Court granted certiorari in *Newark*) was *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). In that case, the Fifth Circuit affirmed a jury verdict which had allowed the *Chronicle* to depreciate \$71,200 allocated to a customer list acquired together with other assets from its defunct competitor, the *Houston Press*. (The jury also allocated \$775,400 or about 17% of the total consideration paid for the *Press's* assets to goodwill).

a. The critical holding in *Houston Chronicle* was its rejection of a *per se* rule. Instead, the Fifth Circuit held that an intangible asset is depreciable if (1) it has an ascertainable value separate and distinct from goodwill and (2) it has a limited useful life, the duration of which can be estimated with reasonable accuracy.

b. The *Houston Chronicle* court characterized "mass asset" cases such as *Golden State Towel & Linen Service, Ltd. v. United States*, 373 F.2d 938 (Ct. Cl. 1967) and *Thriftycheck Service Corp. v. Commissioner*, 287 F.2d 1 (2d Cir. 1961) as involving "evidentiary failures on the part of the taxpayer" rather than creating a legal rule of "inseparability".

c. To be sure, other courts had permitted depreciation of intangible assets before *Houston Chronicle*. For examples, see

(1) *Hyatt Roller Bearing Co. v. United States*, 43 F.2d 1008 (Ct. Cl. 1930) (patents) (Treas. Reg. § 1.167(a)(3) cites patents and copyrights as an examples of an amortizable intangible asset);

- (2) *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966), *affirming* T.C. Memo 1964-253 (consumer loans);
- (3) *First Pennsylvania Banking & Trust Co. v. Commissioner*, 56 T.C. 677 (1971) and *Western Mortgage Co. v. United States*, 56 T.C. 677 (1971), 308 F. Supp. 333 (C.D. Cal. 1969) (mortgage servicing rights);
- (4) *Manhattan Co. v. Virginia, Inc. v. Commissioner*, 50 T.C. 78 (1968) (customer lists);
- (5) *North American Service Co. v. Commissioner*, 33 T.C. 677 (1960) (highway advertising service contracts);
- (6) *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969) (wholesale grocer's franchise contracts with retail grocers);
- (7) *Pasadena City Lines, Inc. v. Commissioner*, 23 T.C. 34 (1954), *acq.*, 1955-1 C.B. 6 (bus franchises).

However, it was the *Houston Chronicle* formulation of the test for depreciability which became the central focus of analysis in cases before *Newark*.

d. In response to *Houston Chronicle*, the Service issued Rev. Rul. 74-456, 1974-2 C.B. 65, which accepted the proposition that the question was factual and revoked two earlier rulings which had held that customer lists and insurance expirations could not be depreciated as a matter of law.

2. Post-*Houston Chronicle* case law.

a. After *Houston Chronicle*, taxpayers began to win more often. Three factors can be identified in this change in judicial climate:

- (1) *Houston Chronicle* clarified the test for depreciability and made it an attainable, provable, factual analysis.
- (2) Intangible assets were increasing as a share of total assets; hence, depreciability mattered.
- (3) Regulatory bodies were expressing skepticism about the 40-year write-off convention for an undifferentiated mass of intangible

assets in GAAP and demanding shorter write-offs where factually warranted. See SEC Staff Accounting Bulletin No. 42 (1982); Banking Circular 164-Revised of the Comptroller of the Currency (July, 1985).

b. Taxpayers have succeeded in convincing courts that the following assets are depreciable after *Houston Chronicle*:

(2) cable television franchises, *Chronicle Publishing Co. v. Commissioner*, 68 T.C. 269 (1977)

(3) animal hospital patient records, *Los Angeles Central Animal Hospital Inc. v. Commissioner*, 68 T.C. 269 (1977);

(5) credit information files, *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223 (1975), *acq.*, 1976-2 C.B. 1.

(6) covenants not to compete, *Warsaw Photographic Associates, Inc. v. Commissioner*, 84 T.C. 21 (1985);

(7) insurance expirations, *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446 (Ct. Cl. 1976);

(8) fuel oil customer lists, *Holden Fuel Co. v. Commissioner*, 31 T.C.M. (CCH) 184 (1972), *aff'd*, 479 F.2d 613 (6th Cir. 1973);

(9) core deposits of banks, *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd. without opinion*, 919 F.2d 1492 (11th Cir. 1990); *Colorado National Bancshares, Inc. v. Commissioner*, 60 T.C.M. 771 (1990);

(10) athlete and entertainer contracts, *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978); *KFOX, Inc. v. United States*, 510 F.2d 1365 (Ct. Cl. 1975);

(11) linen and towel supply business customer lists, *National Service Industries, Inc. v. United States*, 379 F. Supp. 831 (N.D. Ga. 1973);

(12) Muzak location contracts, *Business Service Industries, Inc. v. Commissioner*, 51 T.C.M. (CCH) 539 (1986);

(13) newspaper subscription lists, *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); and

(12) trash collection customer lists, *Panichi v. United States*, 834 F.2d 300 (2d Cir. 1987)

c. There were Government victories, as well, however:

(1) In *Ithaca Industries, Inc. v. Commissioner*, 97 T.C. 253 (1991), the Tax Court accepted the Government's argument that "workforce in place" was a regenerating asset which could not be depreciated, but rejected Government arguments that the same rule applied to favorable raw material supply contracts.

(2) In *AmSouth Bancorporation v. United States*, 681 F. Supp. 698 (N.D. Ala. 1988), a district court held that core deposits were non-depreciable (although the holding was carefully based on the court's analysis of the facts presented).

(3) In *General Television, Inc. v. United States*, 449 F.Supp. 609 (D. Minn. 1977), *aff'd* 598 F.2d 1148 (8th Cir. 1979), held that 7,000 at-will subscriber contracts of community antennae television stations were held to be nondepreciable. But see *Donrey, Inc. v. United States*, *supra*, decided by the same circuit.

## II. THE NEWARK CASE

### A. Proceedings to Date

1. On November 10, 1992, the Supreme Court heard argument in *Newark Morning Ledger Co. v. United States*, No. 91-1135.

2. The Petitioner in *Newark* had prevailed in a bench trial before a New Jersey district court and obtained a judgment that it (as purchaser of the Booth newspapers) was entitled to depreciate \$68 million allocated to "wasting intangible assets consisting of relationships with specific persons who subscribed to the Booth newspapers on the date of acquisition." 734 F. Supp. 176 (N.D.N.J. 1990). In the lower court, the Government stipulated the life of the relationships but argued for a much lower value based on its experts' estimate of the cost of soliciting a similar number of subscribers.

3. The Third Circuit reversed. 945 F.2d 555 (3rd Cir. 1991).

a. The Third Circuit stated that

"... the Service is correct in asserting that, for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable."

b. The Third Circuit acknowledged the apparent conflict between this approach and *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987) (allowing depreciation of newspaper subscription lists) and *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd per curiam*, 919 F.2d 1492 (11th Cir. 1990) (allowing amortization of bank core deposits).

c. The Third Circuit said these cases were in conflict with *Houston Chronicle*, apparently accepting a Service argument that:

"...the two-prong test articulated in *Houston Chronicle* was intended to enter the notion that some intangible assets, although not necessarily goodwill, were nonetheless so intertwined with goodwill as to be nondepreciable as a matter of law in all cases -- *i.e.*, the mass asset rule. The Service adds, however, that there is no indication in *Houston Chronicle* that the court intended to hold that goodwill itself was depreciable or to replace what it had confirmed to be the traditional definition of goodwill with the residual definition such as is urged by Morning Ledger in the instant dispute.

**Comment:** In reading these passages, it is useful to recall that the assets involved in *Newark* and *Houston Chronicle* were precisely the same -- newspaper subscriptions-- and that the two circuits reached opposite judgments.

4. The Government acquiesced in the Petitioner's petition for a writ of certiorari earlier this year and the Supreme Court agreed to hear the case.

## B. Arguments In the Briefs

### 1. Goodwill: Substantive Concept or Indefinite Residual

a. The Government argues that goodwill is "definitional", *i.e.*, that *any* value arising from "future revenues from the continued patronage of an acquired business fall within the core of the concept of goodwill." (Government Brief at 19).

(1) As support for its definitional approach, the Government cites the often-repeated description of goodwill in *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436 (1893) as "...the expectancy that old customers will result to the old place."

(2) One consequence of this view, explicitly adopted by the Third Circuit, is to prohibit the use of the "income method" of valuing customer-based intangibles since that method is based on income to be derived from futures patronage.

**Comment:** The scope of this argument may well prove to be the Government's downfall if it should lose the *Newark* case. The "income method" is the preferred method for valuing intangibles because it reflects how real buyers and sellers value such property. In the unlikely event the Supreme Court adopts the ban on the "income method", Service will be faced with interesting task of explaining why a taxpayer should not be permitted to use the cost method to value a gift of a valuable patent to his heirs. Indeed, patents illustrate the problem. What makes a patent for a miracle drug valuable is the same future revenue from continued patronage which the Government seeks to define as goodwill.

(3) The Government dismisses the conflict between this definitional concept of goodwill and the residual approach mandated by Code sections 338 and 1060 in a footnote to its brief by stating:

"...these regulations make clear that goodwill has a separate and distinct substantive meaning, for only these "intangible assets" that are distinct from "goodwill" may be valued and



assigned a basis under the regulations". (Emphasis in Government Brief at page 27, footnote 23).

**Comment:** This attempted explanation falls short, however. The regulations under section 1060 clearly contemplate a zero allocation to goodwill in an ongoing business if the amounts properly allocable to Class I, II, and III assets absorb the full, fair market value of the purchase. Treas. Reg. §1.1060-IT, Example 2. If goodwill has substantive content, this is an improper result.

b. The Petitioner argues that goodwill is not a substantive concept. The Petitioner argues that:

"Properly understood, goodwill is not a substantive concept that overrides the plain language of section 167 and renders nondepreciable certain wasting business assets with proven ascertainable lives. Instead, it is a residual concept that encompasses certain non wasting and undeterminably lived aspects of a business that remains after all identifiable tangible and intangible assets are valued. (Petitioner's Brief at 19).

(1) The Petitioner first argues that the federal income tax is a tax on net income and that to properly reflect income, "all wasting assets used to produce income are depreciable." Section 167 provides that depreciation "shall be allowed" for wasting property used in business.

(2) The Petitioner argues that regulatory prohibition on depreciation of goodwill can only be consistent with the statutory command of section 167 if confined to assets which do not have a determinable life.

(3) The Petitioner then notes that recent statutory and regulatory positions expressly recognize that goodwill is not amenable to specific identification, *e.g.*, Code Section 1060, Treas. Reg. § 1.338(b)-2(T)(b)(2) and Treas Reg. § 1.1060-1T(d).

**Comment:** The Petitioner's primary difficulty with this argument is that these provisions came into effect after the Booth newspapers were acquired. However, the Service has persuaded the Tax Court to adopt the view that the residual method was required under prior law as well. *Banc One Corp. v. Commissioner*, 84 T.C. 476 (1985), *aff'd*, 815 F.2d 75 (6th Cir. 1987).

2. ***Houston Chronicle: Landmark or Footnote*** -- One of the central disputes in the case is about what the law has been for the past twenty years since the Fifth Circuit's decision in *Houston Chronicle Publishing Co. v. United States*, *supra*.

a. The Petitioner argues that *Houston Chronicle* definitively rejected a *per se* rule of nondeductibility for customer lists and similar assets.

b. Somewhat surprisingly, the Government explicitly argues for the adoption of a *per se* rule under which intangible assets sufficiently associated with future customer patronage would be considered nondepreciable goodwill without regard to proof of limited life. Specifically, the Government states that

"The source of petitioner's logical error is its designation of a particular group of subscribers as a "wasting asset" in an effort to treat them separately from the valuation of goodwill." (Government Brief at 23, Government's emphasis).

In other words, the Government explicitly urges the Court to adopt the mass asset analysis which *Houston Chronicle* rejected.

(1) Not surprisingly, the Government suggests that *Houston Chronicle* was not a landmark and that it is distinguishable "in all of its important respects". The distinctions the Government notes are:

(a) The *Chronicle* did not receive the right to use the name of old newspaper, the Press.

**Query**, would it have made a "meaningful" difference if the Booth newspapers had been renamed by the purchaser in the *Newark* case?

(b) The *Chronicle* did not consider the subscription lists to be self-regenerating. The Government draws from this that *Houston Chronicle* stands for the limited proposition that subscription lists are amortizable only when sold "apart from a going concern". (Government's Brief at 36).

**Comment:** The Fifth Circuit did not view its holding as so limited since it applied a *Houston Chronicle* analysis to allow amortization of purchased football player contracts in an ongoing business setting in *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978).

(c) The Government dismissed Rev. Rul. 74-456, 1974-2 C.B. 65, issued in response to *Houston Chronicle*, as relating only to "an unusual case". Footnote 35 to the Government's Brief clarifies that the "unusual case" is presented when the taxpayer purchases something less than the entire business of another taxpayer.

(2) The analysis to support the Government's per se approach is "mass asset" analysis, *i.e.*, "goodwill" is a lump which includes the value of assets dependent on continuing customer patronage. Goodwill does not depreciate because it "regenerates", *i.e.*, new customers replace old customers.

**Comments:** (1) The difficulty with mass asset analysis is that it proves too much. Consider the case of gas meters owned by a utility. While the utility can show that meters last on average, say, hypothetically 10 years, any particular gas meter may last a much shorter or longer period. In addition, if it does fail, the gas company will surely replace it if there is still a customer at the location to use it. For the same reason, it will pay to maintain its gas meters. If the gas company is successful, it will have more gas meters at the end of the year than at the beginning. Yet no one asserts that gas meters are nondepreciable or "regenerate". But the facts recited here are

those cited by the Government for its "mass asset" approach to goodwill.

(2) Perhaps the most troubling aspect of the Government's approach is the disproportionate emphasis which it places on form. The same asset -- a customer list -- is depreciable if purchased separately or at least without the entire going concern -- but completely nondepreciable if purchased as part of a going business.

(3) The Government's critique of the Petitioner for seeking to depreciate "a particular group" of subscribers seems anomalous in light of the *Houston Chronicle* test. This was the group as to which the Petitioner believed it could prove a limited life (and indeed the Government stipulated that it had done so).

### 3. Double Deduction

a. The Government argues that allowing the Petitioner to deduct the cost of soliciting new subscribers and providing service to the old ones amounts and allowing amortization of the acquired subscribers amounts to a "double deduction" requiring such costs to be amortized. (Government Brief at 28-32).

b. The Petitioner responds that this argument is simply another iteration of the "mass asset" argument. It notes that no "double deduction" is involved when a taxpayer deducts the cost of maintaining a depreciable machine.

**Comment:** Although the Petitioner's basic response to this argument would seem sufficient, the Government's argument does focus on a different and more difficult issue -- the difficulty boundary between deductible "repairs" and "capitalized" improvements. See *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992). The usual justifications for not requiring capitalization of expenditures giving rise to long-lived, self-created intangible assets are the difficulties of distinguishing between successful and unsuccessful efforts and correctly apportioning costs to the successes. In a purchase context, this difficulty is resolved because the parties determine the value by arms-length negotiation.

Largely for this reason, new section 197 applies only to "purchased assets". See V. below.

4. **Settled Expectations.** Both sides claim the force of precedent and argue that the other's position is inconsistent with settled decisional law.

**Comment:** One amicus argued that it had acquired over forty newspapers in reliance on the Petitioner's position -- and would not have done so if the Government's position were the controlling rule. While this position seems extreme, adoption of the Government's position by the Court will clearly have a negative effect on assumed business values where significant intangibles were involved. Indeed, the whole catalogue of taxpayer victories will be called into question.

### III. IMPACT OF *NEWARK*

A. Absent enactment of section 197, the impact of a decision in the case will be substantial.

#### B. Possible Outcomes

1. **Taxpayer Victory.** The Supreme Court might simply reverse the Third Circuit and reinstate the district court judgment, holding that the issue was factual and determined by the trier of fact without clear error.

- a. This result would confirm the taxpayer view of *Houston Chronicle* and definitively reject a *per se* rule or mass asset analysis.

- b. It would leave open a number of issues such as the propriety of front-loaded depreciation (as opposed to straight-line) and the appropriateness of competing valuation method and discount rates.

2. **Limited Taxpayer Loss.** The Court could hold that the district court erred on the facts presented or with respect to the valuation methodology utilized and render a limited decision which leaves the issue open for other fact patterns.

a. This is the "fall back" position of many of the amici who urged the Court not to render a sweeping decision without reference to the facts of the case.

b. Such an approach, focused on detail, rather than general principle, might answer some of the methodology issues described in II.B.1.b. above.

3. **Government Victory.** The Court may hold that any intangible value which is attributable to "recurring customer patronage" is nondepreciable goodwill unless the asset is purchased separately from a going concern or is a fixed-term contract.

a. This decision will immediately cause planning pressures for "separate sales". Just what must a purchaser "leave behind" in order to achieve a depreciable asset outcome?

b. Questions will also be raised about fixed-term contracts. What if they are renewable? Fixed-term but cancelable on notice or an event of default.

c. Asset values will fall for firms with intangible assets which had heretofore been depreciated but now are treated as goodwill.

**Comment:** Note that all of these effects focus on the legal form of the arrangement rather than the period of time it is likely to be economically useful.

#### IV. LEGISLATION

A. In 1991, Ways and Means Chairman Rostenkowski introduced H.R. 3035 which generally provided that purchased intangible assets (including goodwill) would be amortizable over 14 years on a straight-line basis.

B. The Treasury Department immediately endorsed the bill and strongly supported its enactment at the October 1991 hearings before the Ways and Means Committee. The Treasury noted in its testimony that the bill would reduce disputes by eliminating the need to distinguish between goodwill and depreciable intangibles

and would bring the tax treatment of such items into better harmony with generally accepted accounting principles, SEC and bank regulatory policy, and the tax policies of major trading partners. Hearings before the House Ways and Means Committee, 102d Cong., 1st Sess. (October 2 and 27, 1991). Serial 102-76.

C. The House and Senate reached agreement on a 14-year amortization rule with elective retroactivity for open years in H.R. 4210; however, the bill was vetoed by the President.

D. In H.R. 11, the House and Senate again reached agreement on a 14-year amortization rule; however, the bill did not include a broad retroactivity provision. As this outline goes to press, it seems likely that H.R. 11 will be vetoed.

## V. COVERAGE OF SECTION 197 IN H.R. 11

References in brackets ([ ]) are to subsections and paragraphs of section 197 as reported by the H.R. 11 Conference Committee unless otherwise stated.

A. **Purchased Intangibles.** The bill applies to purchased intangibles only. Self-created intangibles are not affected provided that they are not created in connection with acquisition of a trade or business [(d)(1)(A) & (B)]. However, licenses, permits, covenants not to compete, franchises, trademarks, and tradenames (hereinafter collectively referred to as "business rights") are excluded from this rule, thereby subjecting self-created assets of this sort to the 14-year amortization rule even if self-created. [(c)(2)(A), (f)(3)(F)(4) and Act section 4501(c)]. The Conference Report provides several clarifications:

1. Intangibles produced for the taxpayer under a contract entered into before production of the intangibles are considered "self-created".
2. However, contracts for use of a section 197 intangible (or renewals of such contracts) are not "self created"; hence such contracts will be subject to 14-year amortization unless the Treasury provides an exception under its regulatory authority. See V.E. below.
3. The Conference Report states that section 197 applies to assets which are "deemed" purchased under section 338.
4. Section 197 generally does not apply to any amount that is otherwise currently deductible (*i.e.*, not capitalized under current law (other than amounts paid for "business rights" described above) and that no inference is intended as to the current depreciability of any item subject to section 197.

B. **Items Included As "Section 197 Intangibles".** The following are "section 197 intangibles":

1. **Goodwill and going concern value** [(d)(1)(A) & (B)];
2. **Workforce** (*e.g.*, workforce in place, assembled workforce, education, training, terms of employment, etc. [(d)(1)(c)(i)]);
3. **Information base** (*e.g.*, books and records, files, manuals, customer lists and records, etc. [(d)(1)(c)(ii)]);
4. **Know-how** (*e.g.*, patents, copyrights, formulas, processes, package designs, computer software, film, sound recordings, and videos), but see II.C. 5, 6 and 8 below [(d)(1)(C)(iii)];
5. **Customer-based intangibles** (*e.g.*, customer lists, core deposits, insurance in force) [(d)(1)(C)(iv)] and (d)(2); however, the Conference Report clarifies that only value from future provision of services are included in section 197 -- amounts paid for accounts receivable would continue to be governed by prior law;
6. **Supplier-based intangibles** (*i.e.*, the value resulting from the future acquisition of goods or services to be used or sold by the taxpayer such as favorable supply contracts or favorable shelf space) [(d)(1)(C)(v) and (d)(3)];
7. **"Similar" items** to workforce, information base, know-how, customer-based intangibles or supplier-based intangibles [(d)(1)(c)(vi)];
8. **Licenses, permits, and other rights** granted by governmental units (even if granted for an indefinite expected to be renewed indefinitely, *e.g.*, liquor licenses, takeoff "slots", and broadcast licenses) [(d)(1)(D)];
9. **Covenants not to compete** and other similar arrangements (*e.g.*, consulting arrangements exceeding reasonable compensation) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or substantial portion thereof); [(d)(1)(F)]; and  
  
**Comment:** The Conference Report states that amounts paid in later years (*i.e.*, after the year the covenant is entered into) are amortized over the remaining 14-year period and that the section does not change existing law concerning the proper allocation of purchase price between stock and a covenant not to compete.
10. **Franchises, trademarks, and tradenames** (including area distribution rights) but see III.F.6. below [(d)(1)(F)].



**C. Exceptions to the Definition of a Section 197 Intangible.** The following are excluded from the definition of "section 197 intangibles":

1. **Interests in a corporation, partnership, trust or estate [(e)(1)(A)];**
2. **Interests under certain existing financial contracts** (*e.g.*, futures contracts, national principal contracts, foreign currency contracts, interest rate swaps, etc.) [(e)(1)(B)];
3. **Interests in land** (*e.g.*, fee interests, grazing rights, and air rights; however, airport landing rights, regulated airline routes, and cable television franchises are not "interests in land" and thus are section 197 intangibles) [(e)(2)];

**Comment:** The Conference Report states that the bill does not apply to any amount that is properly taken into account in determining the cost of property which is not a section 197 intangible. Thus, no section 197 intangible arises in the acquisition of a favorably located office building.

4. **Computer Software**
  - a. Off-the-shelf software (*i.e.*, computer software which is (i) readily available for purchase by the general public, (ii) subject to a nonexclusive license, and (iii) has not been substantially modified)
  - b. Other software is excluded if not acquired as part of the acquisition of a trade or business [(e)(3)];
5. **Separately acquired assets.** If not acquired as part of a trade or business, the following are not section 197 intangibles:
  - a. Intellectual property (*e.g.*, films, videos, books) not acquired in connection with acquisition of a trade or business or a substantial portion thereof [(e)(4)(A)];
  - b. Contracts to receive tangible property or services under a contract or granted by a governmental entity [(e)(4)(B)];
  - c. Interests in patents and copyrights [(e)(4)(C)];
8. **Interests under existing leases of tangible property (real or personal) [(e)(5)(A)].**

9. **Interests under existing indebtedness** (*e.g.*, favorable financing and premiums) [(e)(5)(B)];

**Comment:**

(1) The exclusions from the bill for leases, debt, and financial instruments are limited to "existing" instruments, although Treasury may except them by regulation if they have duration of less than 14 years.

(2) However, footnote 10 to the Conference Report states that a "temporal interest in property, outright or in trust, may not be used to convert a section 197 intangible into property that is amortizable more rapidly than the 14-year period specified in the bill."

10. **Professional sports franchises** (see Code section 1056) [(e)(b)] and;

11. **Transaction costs.** Professional fees and transaction costs insured in tax-free transactions. [(e)(7)]

**Comment:** The Conference Report states that the transaction cost exclusion was adopted "because of concern that some taxpayers might attempt to contend that the 14-year amortization provided by the provision applies to any amounts that may be required to be capitalized under present law but do not relate to any asset with a readily identifiable useful life" and cites *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992). This passage is followed by triple "no inference" language. But does the statutory language imply section 197 would apply to taxable transactions?

**D. Trade or Business Purchases.** In a number of situations, the applicability of section 197 is dependent whether the intangible is acquired in a transaction "involving the acquisition of assets constituting a trade or business or substantial portion thereof" (*e.g.*, films per (e)(4)(A)). While the statute does not further define this critical phrase, the Conference Report offers several helpful clarifications. The Conference Report states that:

1. It is anticipated that the Treasury Department will exercise its regulatory authority to require any intangible property that would otherwise be excluded from the definition of the term "section 197 intangible" to be taken into account under the bill under circumstances where the acquisition of the intangible property is, in and of itself, the acquisition of an asset which constitutes a trade or business.

2. In the determination of whether a substantial portion" has been acquired, all facts and circumstances including the nature and amount of retained assets

are to be considered; however, the value of retained assets is not solely determinative.

3. If a group of assets constitutes a trade or business for section 1060 purposes, (*i.e.*, goodwill or going concern value could in any circumstance attach to such assets), the assets constitute a trade or business for section 197 purposes.

4. Acquisitions of a franchises, trademarks or trade names are always considered to involve the transfer of a trade or business.

5. Only assets acquired from the same person or a related person are considered in making the determination.

6. Employee relationships that continue or covenants not to compete are taken into account in making the determination as to whether a trade or business has been transferred.

**E. Treasury Regulatory Exclusion Authority:**

1. By regulation, the Treasury may exclude contract rights or government grants if:

a. The right is not acquired in connection with the assets of a trade or business or a substantial portion thereof and

b. The right either

(1) has a fixed duration of less than[14] years, or

(2) is fixed as to amount and properly amortizable under a method similar to the unit of production method (*e.g.*, Clean Air Act emission rights) [(e)(4)(D)].

2. The Conference Report states that the mere fact that a taxpayer will have the opportunity to renew a contract or right on the same terms as are available to others, on a fair market value basis and in which the taxpayer is not "contractually advantaged" is not to be taken into account in setting terms for purposes of this provision. Otherwise, the treatment of renewal options and the likelihood of renewals is left to regulations.

## VI. TREATMENT OF SECTION 197 INTANGIBLES

**A. Fourteen-year Amortization** - Section 197 intangibles are amortized on a straight-line basis over 14 years under H.R. 11. [(a)] If section 197 applies, no other depreciation or amortization is allowable. [(b)].

### **B. Dispositions**

1. No loss would be recognized by reason of disposition, abandonment, or worthlessness of a section 197 intangible if the taxpayer retains other section 197 intangibles acquired with the intangible disposed of. [(f)(1)(A)]

2. The basis of the remaining section 197 intangibles will be increased by any loss which is not recognized under the prior paragraph. [(f)(1)(B)]

3. Section 41(f)(1) aggregation rules apply. Accordingly, all members of a controlled group are treated as a single taxpayer.

4. The disposition rule does not apply to "separately acquired" intangibles which are not governed by section 197.

**C. Revision of Section 1060 Allocation Rules** - In Section 1060, the term "section 197 intangible" replaces "goodwill and going concern value". Act section (e). The Conference Report states that it is anticipated that the residual method specified in the regulations will be modified to treat all amortizable section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which the bill applies.

**D. Treasury Regulations** - The Treasury will have general regulatory authority to clarify the scope of the rules and to prevent avoidance by related persons or otherwise. [(g)] In addition, the Treasury has authority to exclude assets with lives of less than 14 years from section 197 and to prescribe depreciation in such event. [(e)(4)(D) and Act section 4501(b).]

### **E. Treatment as Depreciable Property.**

1. A section 197 intangible is treated as property subject to the allowance for depreciation provided by section 167. [(f)(7)]. If held for more than one year, qualifies as property used in a trade or business for purposes of section 1231. Section 1245 recapture applies as does section 1239 (relating to related-party transactions).

2. If computer software is not treated as a section 197 intangible, it is to be amortized on a straight-line basis over 36 months beginning with the month of acquisition. [Act subsection 4501(b) and new code section 167(f).]

3. Amounts paid for a covenant not to compete are treated as an amount chargeable to capital account. [(f)(3)].

## **F. Special Rules**

1. **Determination of adjusted basis.** Present allocation principles (i.e., section 1060 allocation of purchase price) continue to apply. Contingent amounts are to be added to basis in the month paid and amortized over the remaining 14-year period, if any.

2. **Nonrecognition Transactions.** Section 197 intangibles acquired in transactions to which Sections 332, 351, 361, 721, 731, 1031 or 1033 apply or transactions between members of a consolidated return group will receive the same treatment (i.e., remaining amortization period) as in the hands of the transferor to the extent that the transferee's basis does not exceed that of the transferor [(f)(2)]. The Conference Report states this rule also applies to partnership terminations under section 708(b)(1)(B) of the Code. Boot or gain recognition results in a new 14-year amortization period for the recognized amounts.

### **3. Partnership Transactions**

a. Generally, a taxpayer's acquisition of an intangible held through a partnership will be treated as an acquisition (and hence trigger a new 14-year amortization period) only if, and to the extent that, the taxpayer obtains increased basis in the intangible. Note that section 754 elections trigger the new period to the extent of the step-up.

b. Effective June 25, 1992, the bill would repeal the special treatment permitted by current law of liquidation payments made for goodwill and unrealized receivables under which such amounts can be treated as guaranteed payments or distributive share (except for partnerships in which capital is not a material income-producing factor.) [Act section 4502 amending Code section 736(b).]

4. **Assumption reinsurance transactions are subject to 14-year amortization.** The Conference Report states that an assumption reinsurance transaction is one in which the reinsurer becomes solely liable to policyholders on contracts issued by the ceding company. Acquisitions of insurance contracts occurring by reason of a section 338 election are treated as assumption reinsurance transactions. However, costs capitalized under section

848 (the deferred acquisition cost capitalization rules enacted in 1990) are not subject to section 197. [(f)(5)]

**5. Franchises.**

a. Renewals of a franchise, trademark, tradename, license or permit are treated as acquisitions of such assets but only with respect to costs incurred in the renewal [(f)(4)(B)].

b. **Section 1253 contingent payment rules.** The bill continues these rules in effect if the contingent payments are made at least annually and are either substantially equal in amount or are payable under a fixed formula. [(f)(4)(C)].

6. **Subleases.** Subleases are treated in the same manner as a lease of the underlying property involved. [(f)(6)]

**IV. EFFECTIVE DATES**

**A. General** - The bill applies to property acquired after date of enactment.

**B. Elections**

1. Taxpayers may elect to apply the bill to all property acquired after July 25, 1991.

2. Taxpayers may elect to apply prior law to property acquired after the date of enactment pursuant to a binding contract in effect on date of enactment and at all times thereafter until the property is acquired.

**C. Anti-Churning Rules** - Rules are provided to prevent avoidance of the requirement that property be acquired after the effective date of the bill and prevent "recycling" of nondepreciable goodwill into a section 197 intangible. [(f)(9)] These rules generally apply to transactions between related parties with respect to property held between July 25, 1991, and the date of enactment.

1. Parties are related if they meet the tests of either Code sections 267(b)(1) or 707(b)(1) (substituting 20% for 50%) or 41(f)(1).

2. Anti-churning determinations are made at the partner level for partnership assets.

3. Taxpayers with less than a 50% relationship may call off the anti-churning rules if the seller elects to pay tax at the highest applicable rate on gain recognized in the transaction.

4. The bill contains broad anti-abuse language directed at transactions to avoid the anti-churning rules.
5. The anti-churning rules do not apply to property acquired from estates.
6. Transferees of persons not permitted to claim section 197 amortization under the anti-churning rules may not claim such amortization to the extent of the basis acquired tax-free in a transaction under section 332, 351, 361, 721, 731, 1031, or 1033.

**D. Retroactivity**

1. H.R. 11 does not contain a retroactivity provision other than the July 25, 1991 election. Thus, neither the Senate nor the House provisions allowing elections to apply the bill to prior years or to elect a percentage of the amount claimed in prior years was included in the conference bill.
2. The Conference Report does include language noting that, were section 197 to be enacted, pending cases would have no precedential value and urging an expedited settlement program.