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Purchase Price Allocations in Cost Basis Acquisitions: Sections 338 and 1060 Under the 1986 Code

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INTRODUCTION: SEPARATE BASKET APPROACH

A. Senate Committee Restatement of 1954 Code "Law"

A sale of a going business for a lump-sum amount is viewed as a sale of each individual asset rather than of a single capital asset. Both the buyer and the seller must allocate the purchase price among the assets for tax purposes. An allocation by the seller is necessary to determine the amount and character of the gain or loss, if any, it will recognize on the sale. An allocation by the buyer is necessary to determine its basis in the assets purchased. This allocation of basis will affect the amount of allowable depreciation or amortization deductions and the amount and character of any gain or loss recognized by the buyer on a subsequent sale, and may have other tax consequences. S. Rep. No. 313, 99th Cong. 2d Sess. 251 (1986). See generally Leighton, Tax and Accounting Problems on the Purchase of a Basket of Assets, 28 N.Y.U. Inst. on Fed. Tax. 75, 77 (1970).

B. Asset Acquisition vs. Stock Acquisition

1. General Business Considerations Under the 1954 Code

Negotiations between the buyer and seller will generally determine whether an acquisition is a purchase of assets or a purchase of stock.

A buyer will generally attempt to purchase assets for a variety of reasons. The strongest motivation to purchase assets is that the buyer can structure the transaction to precisely fit his acquisition strategy. Unwanted assets and liabilities can be excluded from the purchase and, in addition, the haunting spectre of contingent liabilities existing at the acquisition date can be eliminated. Further, the incidence of recapture falls on the seller rather than the buyer.


II. SELLER'S AND BUYER'S ADVERSE TAX GOALS

A. Senate Committee Restatement of 1954 Code "Law"

1. Seller

In general, a seller will benefit if a larger portion of the purchase price is allocable to "pure" capital assets, such as goodwill or going concern value, or (to a lesser extent) to Section 1231 assets. If the sale is taxable to the seller, allocations to capital assets will result in tax at the lower capital gains rates, while allocations
to ordinary income assets such as inventory will result in tax at ordinary income rates. Amounts allocated to Section 1231 assets may result in tax at the preferential capital gains rate, but could produce depreciation recapture income under Section 1245 or 1250 or income recognition under the provisions of the Code. S. Rep. No. 313, supra at 215.

2. Buyer

A buyer, on the other hand, will benefit from an allocation that results in a higher basis for inventory or other assets that would generate ordinary income if resold; to depreciable tangible assets such as buildings and equipment; or to intangible assets having determinable useful lifes, which would be amortizable. S. Rep. No. 313, supra at 251. See generally Rogers, supra at 813.

III. ADVERSE INTERESTS AND CONTRACTUAL ALLOCATION

A. Senate Committee Restatement of 1954 Code "Law"

Although the parties may agree to a specific allocation of the purchase price among the assets and reflect this allocation in the sales contract, the Code does not require such agreement; thus, the contract may simply state the total purchase price. If the parties do make a specific contractual allocation with appropriate regard to value they are generally bound by this allocation for tax purposes. See, e.g., Ullman v. Comm'r, 284 F.2d 305 (2d Cir. 1959); Comm'r v. Danielson, 378 F.2d 771 (3d Cir. 1967), cert. denied, 399 U.S. 853. Similarly, the courts and the Internal Revenue Service generally accept a stated allocation with appropriate regard to value provided the parties have adverse tax interests with respect to the allocation. S. Rep. No. 313, supra at 251 (footnote combined with text).

B. Adverse Interests

1. Benefit-Detriment

The buyer and seller typically are thought to have adverse tax interests because an allocation that favors one party by reducing its tax burden will tend to disfavor the other party by increasing its tax burden. See Klayman, Allocation Problems in Taxable Sales and Purchases of Businesses, 16 So. Fed. Tax Inst. G-1, G-19-G-20 (1981). Seller generally favors larger allocations to assets producing long term capital gain upon sale, e.g., land and goodwill. Klayman, supra at G-20. Buyer conversely generally favors larger allocations to assets that can be depreciated or amortized rapidly, e.g., equipment, real estate improvements under ACRS, and covenants not to compete or property which will be sold shortly in the ordinary course of the buyer's business resulting in ordinary income, e.g., inventory. See Klayman, supra at G-20; Leighton, supra at 76-77. See generally Rogers, supra at 827-28; Attachment "A".

2. Conventional Wisdom as to Tax Consequences of Adverse Interests and Contractual Allocations. Some cases and many commentators apparently assume that where buyer's and seller's tax interests are adverse, their contractual allocation of the purchase price to the component assets generally will be upheld. See, e.g., Ullman v. Commissioner, 264 F.2d 305, 308 (2d Cir. 1959) ("The tax avoidance desires of the buyer and seller in such a situation are ordinarily antithetical, forcing them, in most cases, to agree upon a treatment which reflects the parties' true intent. . . ."); accord, Balthorpe v. Commissioner, 356 F.2d 28, 32
(5th Cir. 1966) ("The parties' competing tax interest will be a solid barrier to unrealistic allocations."); Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961) ("Generally speaking, the countervailing tax considerations upon each taxpayer should tend to limit schemes or forms which have no basis and economic fact. The Commissioner should be slow in going beyond the values which the taxpayer states when such countervailing factors are present. Such a result gives certainty to the reasonable expectations of the parties and relieves the Commissioner of the impossible task of assigning fair values to goodwill and to covenants."); Dubin, Allocation of Cost to, and Amortization of, Intangibles in Business Acquisitions, 57 Taxes 930, 940 (1979); Faber, Allocation of Purchase Price on Acquisitions Recapture; Going Concern Value, 39 N.Y.U. Inst. on Fed. Tax. 6-6, 6-19 (1982). Ganier, Treatment of Goodwill: Allocating a Lump-Sum Purchase Price Among Mixed Assets of a Going Business, 7 J. Corp. Tax. 111 (1980). See generally, Rogers, supra at 827 (Attachment A). Indeed, in the context of depreciation recapture, which in many transactions will be the most important allocation, the regulations provide that if a buyer and seller have adverse interests as to the allocation of the amount realized between recapture property and nonrecapture property, any arm's length agreement between the buyer and the seller establish the allocation. Reg. §§ 1.1245-1(a)(5); 1.1250-1(a)(6)(i). Where the parties in fact do bargain at arm's length, their allocation establishes the fair market value of the assets, under the willing buyer-willing seller definition. Ganier, supra.

3. Strong Proof Rule as Between Buyer and Seller.

The prevalent reasoning in the courts is that a taxpayer must offer "strong proof" in order to demonstrate that an allocation of costs to which he acceded in the purchase contract is incorrect. The "strong proof" standard is followed by the Tax Court and by all of the Circuit Courts of Appeal which have addressed it except for the Third Circuit and the Fifth Circuit. There are a significant number of cases where the courts have held that the "strong proof" standard has not been met. Cases upholding the taxpayer's challenge have been few. The courts have stated, however, that in order to successfully challenge an allocation, the taxpayer must show that it either lacked "economic substance" or "independent significance." Rogers, supra at 812 (footnotes omitted).

While the majority of courts follow the "strong proof" standard, a few courts adhere to the stricter standard enunciated in Danielson v. Commissioner. In addition to the Third Circuit, Danielson is followed by the Fifth Circuit and by the United States Claims Court (Proulx v. United States). The burden of the Danielson case is a heavy one for the challenging taxpayer to carry since it must show that the purchase contract is unenforceable because of mistake, undue influence, fraud, duress, and similar causes. Rogers, supra at 812 (footnotes omitted).

4. Economic Substance.

a. Introduction. There is a common "feeling" in cases and commentators that the Service will not disturb the contractual allocation between buyer and seller, provided that they bargain at an arm's length unless bad faith is shown. This perception is probably influenced by the confusingly similar, but different "strong
proof" rule under which the taxpayer challenging a contractual allocation must show strong proof that the allocation does not reflect economic reality. Most of these cases are quick to point out that the general arm's length allocation rule was not applicable on the facts before it. Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961) (seller was apparently unaware that tax benefits which he was willing to confer upon buyer would be a tax detriment to him.); accord, Kalamazoo Oil Co. v. Commissioner, 693 F.2d 618 (6th Cir. 1982) (allocation to covenant not to compete with retiring shareholder not upheld since aged shareholder did not intend to compete and spent much of his time out of state vacationing in Florida and covenant ran for life rather than a reasonable period of years); O'Dell & Co. v. Commissioner, 51 T.C. 461, 468-69 (1974) (listing of authorities denying allocation to covenant not to compete where no desire or ability).

The reality is that the courts in this area are pulled in "opposite directions" by the substance over form doctrine and a desire of certainty and ease of judicial administration. Furthermore, cases and commentators appear at times confused by the special lore that has developed in the covenant not to compete area such as the severability test and intent test.

b. Severability Test Yielding to Economic Reality Test. The "severability" test focused on whether a covenant not to compete could be segregated and valued separately from other assets transferred, particularly goodwill. See Beghe, Income Tax Treatment of Covenants Not to Compete, Consulting Agreements and Transfers of Goodwill, 30 Tax Law. 587, 590 (1977). The severability test has been rejected by most circuit courts in favor of the "economic reality test". See Schulz v. Commissioner, supra at 56; Beghe, supra at 591. Under the economic reality test a covenant not to compete "must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement." Schulz v. Commissioner, supra at 55.

c. Intent Test. The "intent" test sometimes conflicts with the economic reality test. Compare Annabelle Candy Co. v. Commissioner, 314 F.2d 1, 7 (9th Cir. 1962), and Better Beverages, Inc. v. United States, 619 F.2d 424, 429-30 (5th Cir. 1980) with Coven v. Commissioner, 66 T.C. 295 (1976).


Buyer and seller are not necessarily bound by an allocation of purchase price, but at least as to allocations to covenants not to compete and to goodwill, they will have a difficult time overruling it. Courts have applied two tests when parties attempt to repudiate a stated allocation to a covenant not to compete or to goodwill or to supply an allocation where none was provided by the agreement. See generally, Beghe, supra at 591-93. Both tests impose strong burdens of proof on a party wishing to disavow an allocation to which he has agreed: the "strong proof" rule and the "Danielson" fraud or duress rule. Compare Ullman v. Commissioner, supra with Commissioner v. Danielson, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967). Tribunals have conflicted as to whether the same, particularly strong proof, test applies to allocations other than to covenants not to compete or goodwill. Compare Grow v. Commissioner, supra with Banc One Corp. v. Commissioner, supra. Moreover, in many cases the factors looked at under the strong proof rule were identical to the factors looked at under the economic substance rule. Compare Coven v. Commissioner, supra, and Montesi v. Commissioner, 340 F.2d 97 (6th Cir. 1965) with Kalamazoo Oil Co. v. Commissioner, supra.
The Tax Court itself has said it best in *Lazisky v. Commissioner*, 72 T.C. 495 500-02 (1979).

In part the problems in this area arise the tension between substance and form.

Goodwill is a capital asset which, conventional wisdom tells us, does not waste. Thus, its purchase is a nonamortizable capital investment and its sale generates capital gain.

This simple statement of the law belies the great body of litigation revolving around the question of whether, in any particular case, a proper, or at least tax-enforceable, allocation between a covenant not to compete (covenant) and goodwill has been made. The reports are replete with cases in which one or both parties have resorted to the courts in their effort to be held to a contract other than the one they made, or prove the contract that they would have made had they thought of it.

The courts have reacted in a predictable fashion to this flood of litigation. Pulled in opposite directions by two powerful axioms of law, (1) that a person should be free to contract and that, once made, contracts should be enforced as made (absent certain enumerated exceptions), and (2) that in the tax law, substance must prevail over form, the courts have tended to base their decisions on theories incorporating elements of both these principles. Equally predictable has been the distribution of opinions along a continuum according to the emphasis given any one of these principles in the various jurisdictions. Thus, the so-called "Danielson rule" of the Third Circuit tends to emphasize form. Yet the rule in that circuit also provides for the court's right to look to the substance of the transaction in certain situations:

a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc. [Commissioner v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967)].

On the other side of the continuum are such cases as *Wilson Athletic Goods Mfg. Co. v. Commissioner*, 222 F.2d 355 (7th Cir. 1955). In that case the parties had failed to provide a specific allocation of part of the purchase price to the covenants—which clearly possessed some value. The Seventh Circuit, using purely substance over form reasoning, reversed our holding that the covenant was nonseverable from the goodwill and that, therefore, no amortizable deduction was allowable saying:

But in tax matters we are not bound by the strict terms of the agreement; we must examine the circumstances to determine the actualities and may sustain or disregard the effect of a written provision or of an omission of a provision, if to do so best serves the purpose of the tax statute... Therefore, it was the duty of
the tax court and is our duty here to ascertain the true intent, insofar as tax consequences are concerned. Consequently, it is immaterial whether the contract did or did not define a specified amount as the value of the covenant. In view of the silence of the contract in this respect, it became necessary to determine then from the other evidence whether the covenant had a value, and if so the amount thereof. Where realistically and actually the covenant has a discernible value, the purchaser, of course, may amortize the price paid for it and claim annual deductions pro rata during the life of the covenant. [Wilson Athletic Goods Mfg. Co. v. Commissioner, supra at 357.]

The rule in this Court has tended to fall somewhat between rules of these two cases. In general we prefer to apply the so-called "strong-proof" rule—or more precisely the "economic significance" or "economic reality" version of strong proof as that rule is stated in the oft-cited case of Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961), affg. 34 T.C. 235 (1960):

we think that the covenant must have some independent basis in fact or some arguably relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement. [Schulz v. Commissioner, 294 F.2d at 55.]

Our test is designed to (1) produce predictability (and therefore reduce litigation) by generally enforcing agreements as made, and (2) assure at the same time that the Court is not hamstrung into enforcing obviously substanceless allocations.

Lazisky v. Commissioner, 72 T.C. 495, 500-02 (1979).

5. IRS Challenges: Audit Issues

[The Internal Revenue Service is not bound by the agreement of the parties and may challenge their agreed-upon allocations. The type of allocation that is most frequently challenged by the IRS is the assignment of costs to intangible assets which the purchaser is seeking to amortize.

In order to avoid potential challenges to the assignment of values, the parties must be prepared to show the allocation was bona fide and, above all, reasonable. The allocation will be considered bona fide if it contains values that are separately bargained for at the time the parties come to their "meeting of the minds" in forming their contract. An example of a post-contractual allocation that was rejected by the court was in Payne, which featured an attempt to allocate costs to a covenant not to compete after the original purchase contract had been formed. Rogers, supra at 815 (footnotes omitted).

IV. NON-ADVERSE INTERESTS

A. Senate Committee Restatement of 1954 Code "Law"

The interests of the buyer and seller are not necessarily adverse in the case of Section 1231 assets, since the allocation may result in capital gain (or
nonrecognition of gain under Section 337) to the seller while according depreciable basis to the buyer. In some circumstances, however, the allocation will produce recapture income to the seller. In the case or certain intangibles, the parties' interests also may not be adverse because the seller will recognize capital gain (or no gain under Section 337) with respect to the intangible, while the buyer may acquire an amortizable asset. S. Rep. No. 313 supra at 252 (footnotes omitted).

B. Non Adverse as to Specific Assets or Due to Tax Status of Seller

1. Specific Assets.

In a few situations the detriment-benefit principle does not apply. For example, an allocation to an amortizable customer list, will generate an ordinary deduction for the buyer, but the seller in most instances will recognize a capital gain. Similarly, where the percentage of Section 1245 and Section 1250 recapture is identical to seller, buyer's preference of allocating purchase price to shorter lived depreciable assets over longer-lived depreciable assets, e.g., real estate improvements, will make no difference as to seller. See 1 Bittker, Federal Taxation of Income, Estates and Gifts, ¶ 4.4.4, p. 4-71 note 26 (1981); Amer. Controlled Indus. v. United States, 55 A.F.T.R. 2d ¶ 85-498 (S.D. Ohio 1984). In many instances, however, the percentage of depreciation recaptured will be greater under Section 1245 as to shorter lived assets than under Section 1250 as to real estate improvements, the major exception being non-residential real estate improvements, e.g., plant (unless straight line depreciation is taken albeit on shortened ACRS life).

For a "laundry list" of various assets with buyer's and seller's tax goals see Faber, supra at 6-2-6-4; Leighton, supra at 76-77; Frei, Tax Problems in Corporate Acquisitions Other Reorganizations—From the Seller's Point of View, 52 Taxes 821, 832-33 (1974). Covenants not to compete are a classic example of benefit-detriment under old law. Buyer obtains an ordinary deduction (or amortization of a lump sum paid for a covenant running several years). Seller had ordinary income. Now, seller is no longer adverse as long as capital gains and ordinary income are taxed at the same rate, unless seller has a capital loss carry forward.

For a discussion of the special allocation features of amounts allocated to (a) inventories, (b) favorable leases and contracts, (c) liabilites, and (d) patents, nonpatented technology, trademarks, trade names and franchises, etc. See Rogers, supra at 824, 827-28 (Attachment "A").

2. Status of Seller

In many instances buyer's and seller's interests are not completely tax adverse due to seller particular status. At the one extreme seller may be tax exempt or have available NOL's, Grow v. Commissioner, 44 CCH T.C.M. 1057 (1984); more frequently the buyer and seller may be in different tax brackets and even subject to different accounting rules as to the time value of money which can affect the bargaining status. See 1 Bittker, supra at 4-69-4-71; accord, Klayman, supra at G-20. This more discerning approach has indeed been followed by the courts. See Black Indus., Inc. v. Commissioner, 38 CCH T.C.M. 242, 252-53 (1979); Grow v. Commissioner, supra. Black Indus. acknowledged that agreements reached as a result of arm's length bargaining between parties with adverse legal interests were generally respected where there was no reason to question the bona fides of the transaction, but buyer's and seller's interests in the case before the court were not
"as a practical matter" adverse since seller would offset any gain by net operating losses. In Grow the Tax Court noted that seller recognized "recapture income" in the Section 337 sale, but such income was offset by seller's NOLs. Hence, seller and buyer were not adverse as to the asset purchase allocation. Commentators generally have concluded that allocations in actual Section 337 sales are more likely to be upheld on the theory that the interests of buyer and seller are adverse there, whereas a sale of seller's target stock followed by election of Section 338 by buyer presents a more extreme case of the absence of conflicting interest between buyer and seller. See generally, Ginsburg, Taxing Corporate Acquisitions, 38 Tax L. Rev. 171, 289 (1983); Newman, Structuring the Sale of the Closely Held Corporate Business: Alternative Strategies, 41 N.Y.U. Inst. on Fed. Tax 33-1, 33-53 (1983). Faber, supra at 6-51-5-52 (only rarely in a seller stock sale will there be a contractual allocation between buyer and seller with conflicting interests bargaining at arm's length). Finally, in addition to all of the above factors which may offset the adverse interests of P and T, an allocation between P and T may well be determined by the parties' relative bargaining power, rather than by their best estimate of true fair market value. See Klayman, supra at G-21; Frei, supra at 833.

a. For a list of "recapture income" items which overrode the 1954 Code General Utilities see Rogers, supra at 818 (Attachment "A"). For a discussion of the tax benefit doctrine a similar judicial recapture income override of such shield, see Rogers, supra at 822-24 (Attachment A).

3. Adverse Interests and Section 337 Sale. Some decisions flatly state that T is indifferent to individual asset allocations where Section 337 is applicable. Banc One Corp. v. Commissioner, 84 T.C. No. 35 (March 28, 1985). But the better view is that the interest of buyer and seller are adverse in a Section 337 sale by seller as to "recapture income" (unless T has offsetting NOLs which will often be the case). Black Indus., Inc. v. Commissioner, supra at 253; accord Grow v. Commissioner, supra (seller had ordinary income under Section 1245 in Section 337 sale; applied "strong proof" rule discussed below to allocations between Section 1245 property and non-Section 1245 property). See Ginsburg, supra at 289.

a. Senate Committee View of 1954 Code "Law"

Even if the seller is a liquidating corporation and the sale is governed by Section 337, so that no gain or loss is recognized except for recapture and certain other items, the allocation of purchase price may have tax consequences for the seller. The allocation will determine the amount of recapture income recognized and may affect the extent to which other income is recognized. S. Rep. No. 313, supra at 251 (footnote omitted).

i. The quoted passage has all the "earmarks" of a directive to the drafters of the regulation's to draft an "adversity" standard that takes into account the better reasoned case law surveyed above.

4. Adverse Interest and Section 338 Stock Sale.

a. Section 338 Regulatory Authority.

Section 338(b)(5) provides that P's "grossed up" basis in its recently purchased T stock and basis in its nonrecently purchased T stock, adjusted for liabilities and other relevant items, is to be allocated among the T assets under Treasury Regulations. The TEFRA legislative history provides no further insight into the
factors to be taken into account under these regulations. Commentators have
questioned whether this provision provides the Treasury any greater authority than
under the general regulation writing grant of Section 7805. Ferguson & Stiver,
Taxable Corporate Acquisitions After TEFRA, 42 N.Y.U. Inst. on Fed. Tax. (Part I)
H.R. 4170, does provide some guidance as to such allocation. "It is intended that,
to the extent of the amount taken into account in determining tax attributable to
recapture income from the deemed sale of the target corporation's assets, basis
will be assigned to such assets before the remaining basis, if any, is allocated
(1984). This discussion, however, was concerning the House proposal of Neo-T's
basis after the election as based upon the adjusted "fair market value" of Old T's
stock. H.R. 4170, supra at § 612(k)(5). Nevertheless the allocation provision is
substantially identical to current § 338(b)(5). The Conference provision went back
to the formulation of P's grossed up basis with adjustments for liabilities and other
relevant items as the starting point for Neo-T's basis. And the Conference Report
merely states that the "total basis, as under present law [TEFRA § 338(b)], is to be
allocated among the target corporation's assets under regulations." H.R. Rep. No.
98-861, 98th Cong. 2d Sess. 1220 (1984). The 1984 Bluebook uses precisely the
same formulation. Joint Committee Staff, General Explanation of Deficit
and Means's intent?

b. Adverse Interests. Notwithstanding the general view of commentators, P's
and seller's interests in a Section 338 stock sale are theoretically the same as in an
actual asset sale pursuant to Section 337. In both cases seller is taxed as to its
"recapture income" triggered by the actual or deemed Section 337 sale, assuming
that buyer presumably will shift the recapture income tax liability back to the
shareholders of seller through reducing its seller stock purchase price. But see
Holden & McAndrews, The Sale and Purchase of a Corporate Business in a Taxable
Transaction, 24 Tulane Tax Inst. 32, 41 (1975). The reality is that "commercial
exigencies" often prevent buyer from separately evaluating each asset prior to the
acquisition and, hence, calculating in advance target's recapture income tax
liability. "Moreover, although tax reporting often compels an apportionment of the
aggregate purchase price among the individual assets, the purchaser of an operating
business is buying a unitary economic enterprise, not a basket of discrete assets.
The information yielded by an item-by-item appraisal may thus be of little use to a
purchaser, ... who bases his investment decisions upon earnings or return on
investment rather than underlying asset values." Banc One Corp. v. Commissioner,
supra at P.H. Tax. Ct. Reports 84-262. See generally Morrison, Tax Problems in
Corporate Acquisitions Other Than Reorganizations—From the Buyer's Point of
View, 84 Taxes 843, 847 (1974). Thus, the reality is that, perhaps more than in an
actual asset sale under Section 337, purchaser and target are more likely not to
have allocated the purchase price asset by asset. This is always the case in a
tender offer. But there Section 338 is selcom if ever elected. Ex post facto
allocations by P fare ill in litigation. See Better Beverages, Inc. v. United States,
619 F.2d 424, 429-30 (5th Cir. 1980); Banc One Corp. v. Commissioner, supra.
V. ALLOCATION OF COST WHERE NO CONTRACTUAL ALLOCATION: GOODWILL

A. Senate Committee Restatement of 1954 Code "Law"

1. Valuation Approaches

If the parties to the sale of a going business fail to make an allocation of the purchase price among the assets of the business that is respected for tax purposes, the purchase price (less cash and cash equivalents) must still be allocated among the non-cash assets in proportion to their respective fair market values on the date of the sale. Fair market value has been defined under one formulation as the price arrived at by a willing buyer and a willing seller, neither being under a compulsion to buy or sell. No single method of valuation is regarded as determinative of value in all circumstances. Three commonly accepted methods are the reproduction cost method, the capitalization of earnings method, and the comparable sales method.

2. Goodwill

The valuation of goodwill and going concern value is generally recognized as more difficult than the valuation of tangible assets or certain other types of intangibles. The two most commonly used methods to value goodwill and going concern value are the residual method and the formula method. Under the residual method, the value of the goodwill and going concern value is the excess of the purchase price of the business over the aggregate fair market values of the tangible assets and the identifiable intangible assets other than goodwill and going concern value. Under the formula method, goodwill and going concern value are valued by capitalizing the excess earning capacity of the tangible assets of the business based upon the performance of the business over some period prior to the valuation date. The excess earnings capacity is the excess of the average earnings of the business during this period over an assumed rate of return on the value of its tangible assets. These excess earnings, capitalized at an appropriate discount rate, are deemed to be the value of the unidentified intangibles.

3. Formula Valuations

While the Service has recognized a formula method as a permissible method of valuing goodwill and going concern value, it has also stated the position that the method is appropriate only where there is no better evidence of the value of these intangibles. The courts appear reluctant to apply the formula method because of the subjectivity involved in selecting the appropriate rate of return and capitalization rate. In cases where the value of tangible and identifiable assets can be ascertained with reasonable certainty, the courts have generally rejected the formula approach in favor of the residual method.

4. Second-Tier Allocations

In some cases a taxpayer who has purchased a going business at a premium (that is, the price that it has determined exceeds the apparent aggregate fair market values of the tangible and intangible assets, including goodwill and going concern value) might take the position that it is entitled to allocate an amount in excess of fair market value to the basis of individual assets. Relying on one interpretation of the judicial and administrative authorities, the taxpayer would separately value each of the acquired assets and allocate the premium among all the assets (other than cash and cash equivalents) in proportion to their relative fair

B. Valuation Methods

The most accepted approach to allocation of costs among the assets purchased is to determine their respective fair market values. Fair market value has been sanctioned by the courts and described as the price arrived at by a willing buyer and a willing seller, neither being under the compulsion to buy or sell and both being informed of the facts. The fair market value of some assets is simple to ascertain; for example, the fair market value of cash and cash equivalents such as accounts receivable is determined by their face values, while those of marketable securities may be ascertained by current market quotations. Other less liquid assets must be valued by more sophisticated methods. An independent appraisal of assets generally affords the taxpayer with a reliable, methodically derived valuation that is often upheld in court. While appraisal techniques were originated and developed in the valuation to any asset. The three methods of appraisal most commonly applied are reproduction cost, the capitalization of net income, and the comparable sales method. All three methods are often used in an appraisal as a check on reliability.

Reproduction cost, in general, is the cost of replacing an existing asset with another asset that has equivalent characteristics. An asset with equivalent characteristics is one that offers comparable net income to the business and one that has similar legal and business characteristics. For example, a replacement for a factory would be one with comparable facilities, similar services, and equivalent earning power. In order to determine replacement cost, it is necessary to estimate the costs of reconstructing an asset. Replacement values of some assets, such as machinery and equipment, may be derived from manufacturer's price lists. On the other hand, detailed and time consuming engineering and accounting surveys may be needed to derive accurate cost estimates of other specialized assets.

Once the cost of replacing the asset is determined, this amount is reduced by depreciation in order to compute the current value of the asset.

Three types of depreciation may be taken into account, namely, actual physical deterioration of the asset, functional or technological obsolescence due to changes in style or design occurring since the asset was first placed in service, and economic obsolescence reducing the value of the asset by virtue of a lessened demand for the product or service associated with the asset. These concepts of depreciation differ from the traditional accounting measures of depreciation, which simply allocate the cost of an asset to its periods of use in the business. Further, income tax depreciation concepts are also different since they may have economic goals, such as stimulation of the economy.
Determining depreciation for replacement cost purposes is often based on the experiences of the individual appraiser and thus may highly subjective. Using the replacement cost method as the sole determination of value may be dangerous, therefore, since the IRS's engineers and appraisers may derive less favorable appraisals based upon their own experience and judgment.

A second method of appraisal is the comparable sales method of market data approach. In practice, the comparable sales method requires that an asset be compared with similar assets of the same class and type which have been sold recently. The comparable sales method of appraisal is especially useful in valuing unique assets, such as parcels of real estate, since the method is objectively verifiable and is less dependent on judgment than the replacement cost method. However, the degree to which an asset is unique may also present pitfalls in applying the comparable sales method because the properties to be compared should share as many characteristics as possible. For example, if the value of a factory is to be determined, a comparable factory should be one in a similar (or same) location, and of similar age and functions, etc. Since no two assets are alike, the comparable sales method may be unavailable if there are no comparable sales. It may be necessary to resort to comparing bid and ask prices of comparable assets that are on the market but have not been sold. Care must be taken in drawing comparisons in cases where an actual sale has not been consummated since the bid and ask prices may not reflect fair market value. The comparable sales method is useful, therefore, but its application may be limited by a lack of recent sales of similar assets and by a lack of comparability between the assets.

A final appraisal method is the net income method which, unlike the first two methods previously discussed, focuses on future income flows to be derived from an asset rather than on historical values based on past sales or costs. The future income flows are discounted to reflect their present value once they are determined. There are two critical steps in the net income method, namely, the determination of income flows and the selection of an appropriate discount factor.

Each of these steps involves judgment on the part of the appraiser. For example, both gross income and related expenses have to be estimated in order to derive the future net income stream. This may not be too difficult if the long-term future income streams of an asset are locked in. For example, real property may be subject to a long-term lease and a patent may be subject to a licensing agreement. In other cases, income projections must be made based on past individual or industry experience tempered by industry trends and economic data in general.

The other factor to be determined in the net income method is the discount rate to be used. Different methods of
developing a discount rate have been described, including the "summation" method, the "band of investment" method, and the "comparison" method. The first method, summation, involves assigning percentages to different factors associated with the investment and accumulating them. Some factors may include the risk-free interest rate on U.S. Treasury securities; a risk factor to be assigned to compensate the taxpayer for using funds to purchase an asset for a "risky" venture, rather than investing the funds in Treasury securities; a rate to be assigned to compensate the taxpayer for the efforts it expends in managing the asset; and finally, a rate to compensate the taxpayer for the nonliquidity of the asset.

The "band of investment" method requires identification of the cost of financing the asset (i.e., the cost of borrowing the money) and the rate of return required on the equity of the taxpayer. The percentage of the asset financed by the taxpayer's own funds (equity) is multiplied by the required rate of return on equity. Similarly, the percentage of debt financing is multiplied by the interest rate. These two products are then added to derive the appropriate discount factor. As an example, assume that an asset is financed 80 percent by debt and 20 percent by equity. Further assume that the interest rate is 10 percent and that the required return on equity is 15 percent. The discount factor would be determined as follows:

<table>
<thead>
<tr>
<th>% of value</th>
<th>Rate</th>
<th>Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>20</td>
<td>15%</td>
</tr>
<tr>
<td>Debt</td>
<td>80</td>
<td>10%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In this case, the discount rate would be 11 percent.

The "comparison" method simply involves "comparison of the reactions of buyers and sellers in the market place and is related to the net income provided by properties that have been sold at known prices."

In summary, where the buyer and seller do not agree, allocation of costs is required in a multiple asset purchase. "Fair market value" is the most appropriate measure, but for some types of assets it is difficult to determine. For these assets, appraisal is the best way to measure fair market value. Various methods are available and should be used in combination due to subjective factors involved in each method. Rogers, supra at 815-17 (footnotes omitted).

C. IRS Allocation of Purchase Premium to Goodwill or Going Concern Value.

1. Purchase Premium. A "purchase" premium is the excess of the purchase price over the "fair market value" of the hard assets. Such purchase premium can arise from a number of factors. Commentators have asserted that the Section 338 election presents the most extreme case of "absence of conflicting interest between taxpayers. P is the only interested party. There is no policeman at all. It
is, therefore, reasonable to anticipate that the Treasury will approach with enthusiasm the task of writing allocation regulations and will, among other things, focus explicitly on the goodwill issue. "Ginsburg, supra at 289; Newman, supra at 3-53; see generally Ferguson & Stiver, supra at 12-46-12-47. These commentators clearly were referring to the Service's practice under pre-TEFRA § 334(b)(2) of seeking to allocate some or all of such purchase premium paid by P for the T stock upon the subsequent liquidation of T to non-amortizable goodwill or going concern value. See generally, Donaldson, Goodwill and Other Intangibles in Business Acquisitions, 31 N.Y.U. Inst. on Fed. Tax. 291 (1973); Faber, supra at 6-33-6-41; Ganier, supra at 120-28. However, the same problem exists with Section 337 asset sales.

a. For a discussion of various methods of determining the portion of the purchase price allocable to "goodwill" or going concern value, including ARM 34. See Faber, supra; Ganier, supra.

b. The judicial rationale for denial of amortization of purchased goodwill is shaky. Probably the unarticulated rationale is an abhorrence of an amortizable cost basis step-up by buyer without seller paying the appropriate toll charge, coupled with the judicial administrative difficulties encountered in determining the portion of the premium which is amortizable and the appropriate amortization period.

c. For an in-depth discussion of "goodwill" and "going concern" value see Rogers, supra at 820-22 (Attachment A).


Some courts have permitted buyer to carve out from the purchase premium a cost allocable to intangible assets which show have a definitely determinable life so that amortization is possible. See Gregorcich, Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill, 28 Tax Law. 251, 268-71.

a. The case law has gradually evolved away from a "mass asset" rule denying amortization to purchased goodwill, see generally Klayman, supra at G-31-G-32. More recently taxpayers have been able to carve out an amortizable amount where they could show on a statistical basis decline in value or utility, e.g., attrition of customers or of the asset. Klayman, supra at G-32-G-33.

b. In a real sense the current tax treatment allowing deductions for P's payments under target's or its shareholders, covenants not to compete but no deduction for payments for target's goodwill, is a judicial compromise providing a current deduction without the necessity of determining the useful life of the amortizable purchase premium.

c. Commentators readily suggest that the courts can approximate under Cohan the amount of the purchase premium which is amortizable and the appropriate amortization period. In reality, however, the Tax Court has found it relatively easy to make Cohan approximations only where the question was an allocation between a covenant not to compete and non-amortizable goodwill. See, e.g., Peterson Machine Tool, Inc. v. Commissioner, 79 T.C. 72, 86 (1982); accord Levine v. Commissioner, 324 F.2d 298, 302 (2d Cir. 1963). Where, however, the question was allocation to non-amortizable going concern value review courts have
on occasion required some rational basis for the Cohan approximation. See Concord Control, Inc. v. Commissioner, 80-1 USTC ¶ 9248 (6th Cir. 1980), rev'g and remanding in part, 35 CCH T.C.M. 1345 (1976). Moreover, the Tax Court is beginning to recognize the administrative as well as equitable problems with approximation. See Grow v. Commissioner, supra; see also Nessing v. Commissioner, 48 T.C. 505, 512 (1967).

d. See discussion on "Valuation and Amortization of Intangible Assets," Rogers, supra at 824-28 (Attachment A).


The underlying basis for the Service's opposition to buyer amortization of purchase premium is that if the Treasury

"were to allow a write-off of purchased goodwill over a long period of time as a deduction from ordinary income while the sale of goodwill would produce capital gain, we would have a situation in which the purchaser would be able to write-off the goodwill against ordinary income, but the seller would always have capital gain.

I think one of our problems is whether we could ever change one rule without changing the other.

I think that people would be rather reluctant to see the sale of goodwill treated as an ordinary income item under section 1245 or otherwise, and it might be necessary to take the bitter with the sweet. This is part of the problem that would face us.

Statement by Assistant Secretary of Treasury for Tax Policy Edwin S. Cohen, quoted in a Panel Discussion, Accounting Principles or Pooling of Interests, 25 Tax Law. 29, 54 (1971). The anti-selectivity search of TEFRA and the focus of the ALI Corporate Proposals and the Senate Finance Committee Staff proposals on explicit toll charges to T for P cost basis acquisitions, may have intensified the Service's awareness of the imbalance of the current limited rules permitting buyer cost basis acquisition and amortization with seller escaping ordinary income taxation or under Section 337 taxation completely. Commentators had worried that the Service might be tempted to apply a tax benefit theory to seller in a Section 337 sale where buyer obtained an amortizable basis step-up. See Bonovitz, supra at 34 N.Y.U. Inst. on Fed. Tax. at 72-73; Rogers, supra at 822-24. The full impact of Hillsboro National Bank v. Commissioner, supra has yet to be felt in this area. Indeed, General Utilities repeal could be viewed as a surrogate recapture for previously deducted expansion and advertising costs, etc. See Wolfman, 5 Va. Tax Rev. at 696.

a. When the General Utilities repeal is fully in effect as to a selling corporation and the capital gains repeal as to a selling corporation and non-corporate sellers a sale of goodwill is recognized in practical effect as ordinary income. Further reform in this area should therefore permit amortization of purchased goodwill or going concern value over say a 60 month period. Cf. Section 195, providing a amortization of self-created going concern value, i.e., start-up costs.
VI. SECTION 338 RESIDUAL ALLOCATION

A. Senate Committee Restatement of Section 338 Reg's Residual Allocation Method

Proposed and temporary regulations recently issued by the Treasury Department under Section 338 mandate a residual method of allocation (and prohibit a second-tier allocation) in determining the basis of assets acquired in a qualified stock purchase for which a Section 338 election is made or is deemed to have been made, i.e., a stock purchase which is treated as a purchase of assets for tax purposes. The deemed purchase price of the assets is first reduced by cash and items similar to cash, and is then allocated sequentially to two defined classes of identifiable tangible and intangible assets; any excess is allocated to assets in the nature of goodwill and going concern value. After the reduction for cash items, no amount may be allocated to any asset in the next two classes in excess of its fair market value. S. Rep. No. 313, supra at 253 (footnotes omitted).

B. Detailed Analysis of Temporary Section 338Regs Mandatory Residuary Allocation

1. Residual Method.

The adjusted grossed-up basis (AGUB) must be allocated among Neo-T's assets as of the beginning of the day after the acquisition date pursuant to the rules under Temp. Treas. Reg. § 1.338(b)-2T, 51 Fed. Reg. 3591-92 (January 29, 1986). Generally, the AGUB is allocated first to Class I assets, then in turn to Class II, III and IV assets. Class I assets consist of cash, demand deposits and similar bank or savings and loan accounts. Class II assets include certificates of deposit, government obligations, and other readily marketable stock and securities. Class III assets are all assets other than Class I, II and IV assets. Class IV assets are intangible assets in the nature of goodwill and going concern value. Within each class, basis is allocated according to fair market value. Temp. Treas. Reg. § 1.338(b)-2T(b), 51 Fed. Reg. 3591. The amount of AGUB allocated to an asset (other than Class IV assets) is limited to the asset's fair market value at the beginning of the day after the acquisition date. Temp. Treas. Reg. § 1.338(b)-2T(c)(1), 51 Fed. Reg. 3591. However, this fair market value may be subsequently modified with respect to certain contingent income assets. Id.; Temp. Treas. Reg. § 1.338(b)-3T(g), 51 Fed. Reg. 3593-94.

The Temporary Regulations also provide a "transitional allocation election" for stock acquisitions that occurred after 8-31-82 and before 1-30-86, or under a written contract entered into between those dates. Temp. Treas. Reg. § 1.338(b)-4T, 51 Fed. Reg. 23742 (July 1, 1986). A corporation which makes such an election may allocate AGUB pursuant "to the rules of Federal income tax law that apply to the purchase on the acquisition date of a combination of assets for a lump sum." Temp. Treas. Reg. § 1.338(b)-4T(e)(2), 51 Fed. Reg. 23743 (July 1,
1986). In other words, an electing corporation is not bound by the fair market value limitation in the Temporary Regulations. However, any allocation which exceeds an asset's fair market value will be carefully scrutinized by the I.R.S. Temp. Treas. Reg. § 1.338(b)-4T(e)(4), 51 Fed. Reg. 23743 (July 1, 1986). Lee & Bader, supra at n.87. For a discussion on the old allocation rules under Section 338 see Rogers, supra at 817-19 (Attachment "A").

2. Contingent Income

a. Introduction.

The proposed temporary Section 338 3T regulations purport to incorporate such prior law in the form of "general tax law principles." But then they apply such general principles year 2 in the context of a P contingent payment for Old T stock in a manner judicially and administratively unprecedented year 1 - year 2 construct, providing that (1) Old T must recognize in year 2 gain or loss arising from a year 2 change in Old T's deemed sales price, which is reported by Neo-T in year 2 but (2) Neo-T's year 2 tax as to income or loss resulting from such change is determined as if such gain or loss had been recognized "[t]o the extent general tax law principles require seller to account for adjustment events" in Old T's taxable year ending on its acquisition date (year 1) on which P acquired 80% control of T's stock, and (3) Neo-T must separately account in year 2 for such year 2 income as an item of Old T, subject to Old T's tax attributes unexpired as of the end of such year. The temporary regulations specifically leave the matter of any year 2 (or 5 or 25) original issue discount arising out of the year 2 payment to the regulations under Sections 1274 and 1275(d) or 483. Those regulations would impute interest based on the years lapsed since year 1 into the year 2 contingent payment, thereby reducing the principal payment portion of the contingent payment, the only portion that the temporary Section 338 contingent income regulations specifically apply to.

The proposed and temporary Section 338 regulations allocate P contingent payment in year 2 to Neo-T's assets in that year under a "residual method" of allocation formula, which generally limits such year 2 allocation limits allocation to year 1 fair market value, viz., fair market value on the day following the acquisition date, i.e., Neo-T's deemed purchase date, with the exception of goodwill and going concern value. Thus, generally all year 2 contingent payments would be allocated to such goodwill, unless P's base price for control of T was less than fair market value on such deemed purchase date or were attributable to a specified asset.
2. Validity of Regulation's Year 1 - Year 2 Construct.

The temporary and proposed regulations treat Old T as continuing until year 2, as may be seen in Example (4), where P purchased control of Old T on January 1, 1987 and timely elected Section 338. In 1990 (Year 4) P makes a theretofore contingent payment, e.g., an earnout, for the stock of Old T, which is allocated in part to Section 1245 property (because P's base price was less than fair market value).

As a result additional income is recognized under Section 1245 by Old T for 1990 on the deemed sale of Old T's assets. This income must be reported on the consolidated return of new T [Neo-T] for 1990, but it is separately accounted for and may not be absorbed by losses or deductions of P or of new T.

Since the 1982 legislative history treats Neo-T or new T as a new corporation either as the selling or purchasing corporation as to tax liability with a clean slate of tax attributes, one presumed therefore Old T was dead. While the 1984 House bill would have specifically addressed the problem of contingent payouts at the T level, the 1984 Conference bill instead left prior general principles undisturbed. Under such principles a T liquidated T no longer in existence in year 2 when contingent income matures is not taxable in year 2, or year 1. Assuming arguendo that Old T continues, the articulation of the temporary regulations result through measurement of Old T's year 2 income by recomputing its year 1 income and then including that hypothetical increase in year 1 tax in Old T's year 2 income which new T separately reports in year 2 smacks of a legislative solution and clearly contravenes existing general tax principles. The Annual Accounting Principle bars reopening Old T's year 1. Technically, however, the temporary regulation's solution does not constitute reopening year 1 if interest is not charged from year 1 by the Treasury on Neo-T's year 2 addition to income. Nevertheless, the recomputation of year 1 - addition to year 2 as articulated is closer to a legislative solution than the existing judicial year 2 correlative adjustment exceptions to the annual accounting principle.


The proposed time value of money regulations would first separate the contingent P payments for the Old T stock from the non-contingent or fixed payments. If the year 2 contingent P payment does not provide adequate interest for the years elapsed since 1, such proposed regulations bifurcate the year 2 payment into (1) a principal payment equal to the discounted year 1 value of
the total contingent P payment made in year 2 and (2) the balance is considered interest.

The proposed and temporary Section 338 contingent payment regulations expressly state that the examples illustrating year 2 payment by P of theretofore contingent amounts are "exclusive of interest" and cross refer to the regulations under Sections 1274 and 1275(d) or 483 for rules characterizing deferred contingent payments as principal or interest. Implicitly, therefore, the year 1 - year 2 separate return construct of contingent payment allocation and income portion of the proposed and temporary may only apply to the principal portion of the year 2 P contingent payment. The principal portion of the contingent payment was earned by Old T in year 1, but the interest portion was not. Indeed, where the contingent payment claim is distributed to the former T shareholders on the acquisition date, the entire OID is earned by the former T shareholders. A subsequent distribution could result in some OID at the T level, but it should be a consolidated return item of Neo-T in year 2. The final regulations should address this. Lee & Bader, supra at __ (footnotes omitted).

b. For a how-to discussion on tying contingent payments to patents, non-patented technology, trademarks, trade names, and franchises, etc. See Rogers, supra at 828-29 (Attachment "A").

VII. RATIONALE FOR ENACTMENT OF SECTION 1060: PARITY BETWEEN ASSET AND STOCK ACQUISITIONS

A. Audit-Administrative Difficulties According to Senate Committee

The [Senate Finance] committee is aware that the allocation of purchase price among the assets of a going business has been a troublesome area of the tax law. Purchase price allocations have been an endless source of controversy between the Internal Revenue Service and taxpayers, principally because of the difficulty of establishing the value of goodwill and going concern value. The Service lacks the resources to challenge allocations to goodwill or going concern value in all or even a substantial portion of the cases in which it would otherwise assert that the value of those assets are misstated. S. Rep. No. 313, supra at __.

1. Trend Towards Judicial Restraint. The Congressional focus on source of controversies which can't be handled by the audit-judicial system and choosing a bright-line — purchase, premium over value of (hard?) assets — parallels recent judicial developments towards bright-line construction of Section 1221, Arkansas Best Corp. v. Commissioner, 800 F.2d 215 (8th Cir. 1986), and Section 302(c), Lynch v. Commissioner, __ F.2d __ (9th Cir. Oct. 8, 1986). Accordingly, courts (or the regulation drafters) may view amortizable carve-outs from purchase premium with suspicion, especially if such a view maintains the statute. All the more reason for statutory ordinary income treatment of sales of goodwill — going concern value coupled with amortization by the purchaser.
B. Identification of Premium With Goodwill Mandate of Congress in Section 1060.

The Senate Finance committee believes that it is appropriate to treat the "premium" involved in second-tier allocations as a payment for assets in the nature of goodwill or going concern value, rather than a payment in excess of the total value of the purchased assets. The committee therefore is requiring taxpayers to apply the residual method in allocating basis to goodwill and going concern value in all purchases of a going business. The mandatory application of the residual method is also warranted in view of the difficult and uncertain assumptions that are demanded by the application of the formula method and the excessive amount of conflict generated between taxpayers and the Service concerning its application.

C. Incorporation of Section 338 Residual Allocation Regulations

The method adopted by ... [new Section 1060] is identical to that provided in the regulations under Section 338 for allocating purchase price to assets following a stock purchase. Thus, the committee's solution will not only tend to reduce controversies between the Service and taxpayers, it will also eliminate disparities between asset purchases and stock purchases treated as asset purchases under Section 338 insofar as purchase price allocations are concerned.

In adopting the basis allocation rules as prescribed by the Section 338 regulations, the committee intends no inference as to the propriety under present law of methods of allocation in asset acquisitions other than the residual methods.

D. Mandatory Reporting by Seller and Buyer

The committee is also concerned about the potential for abuse inherent in the sale of a going business where there is no agreement between the parties as to the value of specific assets. In many instances the parties' allocations for tax reporting purposes are inconsistent, resulting in a whipsaw of the government. The committee expects that requiring both parties to use the residual method for allocating amounts to nonamortizable goodwill and going concern value under new Section 1060 may diminish some of this "whipsaw" potential. The committee has also authorized the Treasury Department to require reporting by parties to the sale of a business, so that information reporting may be required regarding amounts allocated to goodwill and going concern value and to any other categories of assets or specific assets, and such other information as the Secretary deems necessary or appropriate. S. Rep. No. 313, supra at 253-54 (headings added and emphasis supplied).

VIII. SECTION 1060

A. General Rule: Mandatory Residual Method Allocation
   1. Non-Contingent Purchase Price

   [Section 1060(a)] requires that, in the case of any "applicable asset acquisition," both the buyer and the seller must allocate purchase price in the manner prescribed in Section 388(b)(5). Thus, both parties must use the residual method as described in the regulations under Section 388. See Temp. Treas. Reg. § 1.338(b)-2T. An applicable asset acquisition is any transfer of assets constituting a business in which the transferee's basis is determined wholly by reference to the purchase price paid for the assets. [Section 1060(c)].
Both direct and indirect transfers of a business are intended to be covered by this provision, including, for example, a sale of a business by an individual or a partnership, or a sale of a partnership interest in which the basis of the purchasing partner's proportionate share of the partnership's assets is adjusted to reflect the purchase price.

A group of assets will constitute a business for this purpose if their character is such that goodwill or going concern value could under any circumstances attach to such assets. For example, a group of assets that would constitute an active trade or business within the meaning of Section 355 will in all events by considered a business for purposes of this provision. Moreover, businesses that are not active businesses under Section 355 will also be subject to this rule.

In requiring use of the residual method, the committee does not intend to restrict in any way the ability of the Internal Revenue Service to challenge the taxpayer's determination of the fair market value of any asset by any appropriate method. For example, in certain cases it would be reasonable for the Service to make an independent showing of the value of goodwill or going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets.

[Section 1060(b)] also authorizes the Treasury Department to require information reporting by the parties to an applicable asset acquisition. This may include information regarding amounts allocated to goodwill or going concern value, as well as any other categories of assets or specific assets, and such other information as it deems necessary or appropriate. S. Rep. No. 313, supra at 254-55 (emphasis supplied).

a. Cost basis or "Purchase Price Paid" Requirement
   i. Indirect asset acquisition: partnership interest
      Seller and buyer probably have to report to the IRS information about the inside partnership asset only if Section 754 election is made so Section 734 applies. But query re Section 732(d).
      ii. Inheritance, etc., although resulting in a fair market value basis and, hence, opportunity for misallocations of basis by the new owners poses less of a seller problem, since the decedent is taxed on the passage of title at death, or whenever. Inheritance does not appear to be caught by Section 1060.
      iii. Query do in-kind corporate distributions trigger Section 1060? When a shareholder receives a distribution of property taxable to him/her as a dividend under Section 301, a redemption or even partial liquidation under Section 302, as a liquidating distribution under Section 331 or a "boot" distribution under Section 356 the net effect of these provisions and Sections 311, 336 and 361(b) when fully effective, is to give the shareholder a fair market value basis, Section 301(d) and Sections 302(a) and 1012, and to tax the distributing corporation as if it had sold the assets for fair market value. Indeed, in a qualifying redemption and liquidation, the shareholder is treated as having exchanged all or a part of his/her stock for the distributed property. Sections 302(a) and 331. Does Section 1060 apply? These transactions pose the same potential for abuse that engaged enactment of Section 1060, but the definitional "applicable asset acquisition" trigger of Section 1060(c)(2) refers to transferee's basis determined by reference to "the consideration paid" and the Senate Committee report quoted above refers to "purchases."
iv. "Determined wholly by reference"

Where a controlling shareholder transfers under Section 351 a business for non-recognition property (stock or securities) and for boot, the transferee corporation's basis under Section 362 in the business is not wholly determined by reference on the "boot" consideration it "paid" for the property. Thus Section 1060 appears inapplicable. Boot in a like-kind or similar exchange under Section 1031, etc. should be similarly excluded.

b. Assets Constituting a "Trade or Business"

i. By reference to Section 355's trade or business standard did Congress mean to incorporate existing Treas. Reg. Section 1.355-1(c) and in particular its "independent production of income" and "incidental activities" standards designed to preclude functional divisions or the more liberal 1977 proposed regulations which permit functional divisions?

ii. The case law is no answer because more recent Section 355 decisions are more consonant with (and triggered) the proposed regulations while decisions applying the "partial liquidation" provisions (whose regulation's incorporate the existing judicially discredited Section 355 regulations), readily follow the old Section 355 regulations. Compare Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971), cert. denied 408 U.S. 922 (1971) with Blashka v. United States, 393 F.2d 983 (Ct. Cl. 1968) and Kenton Meadows Co. v. Commissioner, 766 F.2d 142 (7th Cir. 1985).

2. Contingent Purchase Price

a. Allocation

The temporary Section 338 regulations treat taxation of contingent payments in a different section than the residual method allocation section. But the residual method section does speak to allocation of contingent payments — essentially to Class IV, i.e., non-amortizable goodwill, unless tied to a specific asset. Temp. Treas. Reg. § 1.338(b)-T.

The question of who is taxed on contingent purchase price received in a subsequent year (year 2) and how to determine the amount of taxable income is treated in Temp. Treas. Reg. § 1.338(b)-3T, see p. supra, while the legislative history refers only to § 1.338(b)-2T, the residual allocation provisions. Thus, Section 1060 does not appear to incorporate the taxation provisions into asset acquisitions.

b. Income

The Section 338 taxation of Neo-T in year 2 of any gains triggered by reallocation of based upon a hypothetical increase in old T's year 1 income creates a discontinuity with asset acquisitons followed by liquidation of target.

The proposed and temporary Section 338 3T regulations governing year 2 contingent payments illustrate a year 2 increase in Neo-T's separate return recapture income arising from a year 1 non-contingent P price at less than fair market value of Old T's assets plus a year 2 contingent P payment.

Thus, for example, if after the acquisition date there is an increase in the allocable aggregate deemed sale price of Section 1245 property for which the recomputed basis (but not the
adjusted basis) exceeded the portion of the aggregate deemed sales price allocable to that particular asset on the acquisition date, the additional gain shall be treated as ordinary income to the extent it does not exceed such excess amount. The amount of tax on income of Old target recognized [by in year 2 by Old T and reported by Neo-T in its year 2 "separate return"] is determined as if such income had been recognized in Old target's taxable year ending at the close of the acquisition date. Temp. Treas. Reg. § 1.338(b)-3T(j) Ex. (4)(v).

Thus, Neo-T would be taxed in year 2 only to the extent the P contingent payments are allocable as of year 1 or 2 values to assets generating recapture income or other exceptions to the Section 337 General Utilities shield; the deemed Section 337 shield would continue to apply in year 2 to contingent income allocable to non-recapture items.

Yet in a T asset sale structured as a Section 337 transaction, T is liquidated, usually in year 1. Under conventional doctrine a liquidating T is not taxed in year 1 upon distribution to its shareholders of P's contingent payment obligation as to any additional recapture income that might arise in year 2 due to the contingent payments since they cannot be valued in year 1. Moreover, since T will not be in existence when the contingency is resolved under an earnout in year 2, conventional doctrine would not tax Old T in year 2 either as to any recapture income created then by the contingent payments. See Lee & Bader, supra. In contrast in a Section 338 contingent earnout transaction, the proposed and temporary regulations as shown above would tax Neo-T in year 2 as to P's contingent purchase price payments made to the former T shareholders in year 2 to the extent they create additional recapture income. Thus, new discontinuities would be created under the proposed and temporary regulation's approach, contrary to the intent of Congress. Other incongruities arise if target distributes contingent income item to its shareholders in a bootstrap acquisition of targets stock or assets by P. Lee & Bader, supra at ___ (footnotes omitted).

IX. EFFECT OF GENERAL UTILITIES REPEAL

A. General Utilities Concept

1. General Principle: House Committee Restatement of "Law"

As a general rule, corporate earnings from sales of appreciated property are taxed twice, first to the corporation when the sale occurs, and again to the shareholders when the net proceeds are distributed as dividends. At the corporate level, the income is taxed at ordinary rates if it results from the sale of inventory or other ordinary income assets, or at capital gains rates if it results from the sale of a capital asset held for more than six months. With certain exceptions, shareholders are taxed at ordinary income rates to the extent of their pro rata share of the distributing corporation's current and accumulated earnings and profits.

An important exception to this two-level taxation is the so-called General Utilities rule. The General Utilities rule permits nonrecognition of gain by corporations on certain distributions of appreciated property to their shareholders and on certain liquidating sales of property. Thus, its effect is to allow appreciation in property accruing during the period it was held by a corporation to
escape tax at the corporate level. At the same time, the transferee (the shareholder or third-party purchaser) obtains a stepped-up, fair market value basis under other provisions of the Code. Accordingly, the "price" of a step up in the basis of property subject to the General Utilities rule is typically a single, capital gains tax paid by the shareholder on receipt of a liquidating distribution from the corporation.

........

Numerous limitations on the General Utilities rule, both statutory and judicial, have developed over the years. Some directly limit the statutory provisions embodying the rule, while others, including the collapsible corporation provisions, the recapture provisions, and the tax benefit doctrine, do so indirectly. H.R. Rep. No. 426, 99th Cong. 1st Sess. 274-75 (1985) (footnotes omitted).

2. 1954 Codification

Corporate level non-recognition was initially provided as to non-liquidating distributions of appreciated property by dividend or redemption (Section 311), liquidating distributions (Section 336) and sales of assets pursuant to a liquidation (Section 337).

In 1982 Section 338 extended the General Utilities shield to a deemed bulk sales of assets pursuant to a corporate purchase of control of target and election of Section 338. Prior to 1969 liquidating and non-liquidating distributions were treated essentially alike—nonrecognition with minor statutory and case-law exception. From 1969 to 1984, the recognition exceptions to Section 311 were gradually broadened.

B. 1986 Repeal of General Utilities

1. Introduction. Congress in the Internal Revenue Code of 1986 repealed the General Utilities' corporate-level shield in Section 336 governing liquidating distributions, Section 311 governing nonliquidating distributions, and Section 338 stock acquisitions treated as asset acquisitions. Additionally, it repealed entirely old Section 337 governing sales pursuant to a corporate liquidation and Section 333 governing nonrecognition at the shareholder level liquidations, while retaining in new Section 337 the General Utilities shield with modifications for subsidiary into parent liquidations under Section 332. The 1986 Act also limited recognition of losses completely in Section 311 and partially in Section 336. To back-stop the repeal of General Utilities Congress also imposed a 10-year taint of corporate level recognition as to built-in appreciation at the time of conversion from a C corporation to an S corporation for S corporation elections of existing C corporations after December 31, 1986.


The conference agreement provides an additional transitional rule for certain closely held corporations. Corporations eligible for this rule are generally entitled to present law treatment with respect to liquidating sales and distributions occurring before January 1, 1989, provided the liquidation is completed before that date. A liquidation will be treated as completed under the same standard that is applied under the general transitional rules. However, this special transitional rule requires the recognition of income on distributions of ordinary income property
(appreciated property that would not produce capital gain if disposed of a taxable transaction) and short-term capital gain property. Thus, the failure of an eligible closely held corporation to complete its liquidation by December 31, 1986, or otherwise to satisfy the general transitional rules, will result in the loss of nonrecognition treatment for the distribution of appreciated ordinary income and short-term capital gain property. Corporations eligible for this rule may also make an S election prior to January 1, 1989, without becoming subject to the special S corporation rules [10-year taint, of new Section 1374 of the conference agreement. Such eligible, electing corporation, however, will be subject to the 1954 Code version of Section 1374.

A corporation is eligible for this rule if its value does not exceed $10 million and more than 50 percent of its stock is owned by 10 or fewer individuals who have held their stock for five years or longer. Full relief is available under this rule only if the corporation's value does not exceed $5 million; relief is phased out for corporations with values between $5 million and $10 million. For purposes of this rule, a corporation's value will be the higher of the value on August 1, 1986, and its value as of the date of adoption of a plan of liquidation (or, in the case of a nonliquidating distribution, the date of such distribution), and aggregation rules similar to those in section 1563 apply, except that control is defined as 50 percent rather than 80 percent.

In the case of nonliquidating distributions, apart from changes in the case of ordinary income property and short-term capital gain property, present law is otherwise retained for distributions to qualified, long-term individual shareholders (but only during the transitional period) for corporations qualifying under the closely held corporation transitional rule. H.R. Rep. No. 841, supra at II-206 - II-207 (emphasis added);

1. A similar 2 year transitional rule applies to Section 338. Id. § 631(d)(7).

2. The statute itself actually omits the closely-held transition rule for Section 311, See H. Cong. Res. 395 ¶(75), and 5-year holding requirement, Id. ¶(74), 132 Cong. Rec. H8445, H8447 (Rep. Rostenkowski).

C. Effect of General Utilities Repeal on Cost Basis Corporate Acquisitions

1. Introduction.

The central inquiry here is the effect of corporate level recognition upon a sale of assets pursuant to liquidation, liquidating distribution, or deemed sale pursuant to Section 338 of appreciation in the corporate assets upon the question of cost or carryover basis acquisition. The discussion below assumes that the target is a C corporation, i.e., corporate income is taxed at the corporate level rather than as a flow through to shareholders as in an S corporation.

2. Closely-held target corporations.

a. General Utilities Repeal renders cost basis acquisition impractical.

In most cases the tax cost at the target level of recognition of all appreciation in the target's assets upon a sale pursuant to liquidation or upon a Section 338 election deemed sale outweighs the present value to the purchaser or
Neo-T of the tax benefits from a step-up in basis to fair market value. Exceptions would arise where target has NOLs that shelter such step-up or target's recognition will be at lower brackets than the acquiring company's tax rates which the increased deductions from a cost basis acquisition would offset. Thus, as a practical matter purchasing corporation will give up cost basis acquisition treatment. See Thompson, 5 Va. Tax Rev. at 700.

b. **Lack of carryover basis asset acquisition option.**

The acquiring corporation ("P") generally prefers an asset acquisition. The primary reason under old law was both to pass the incidence of the recapture tax back to the target shareholders and to avoid hidden liabilities. As shown above, the target shareholders now generally would not agree to a cost basis asset acquisition since the incidence of double taxation would be too heavy. They would instead agree under the new Code to a carryover basis stock acquisition or, if it were possible, a carryover basis asset acquisition for a somewhat lessened sales price than in a cost basis acquisition, i.e., fair market value, but not as great a reduction as the inside full target level recognition tax. Therefore, the principal reason for a cost basis acquisition by P would be to avoid hidden liabilities. However, a carryover basis asset acquisition is permitted under current law only in the context of a qualified reorganization which requires various amounts of the P consideration to consist of stock in P. A purchase carryover basis asset acquisition is not permitted. The consequence of the repeal of General Utilities without the enactment of the elective carryover basis asset acquisition rules of the subchapter C revision means as a practical matter that P must purchase target stock and not elect Section 338 in order to avoid triggering target level recapture tax. Yet, when cast in this manner target hidden liabilities remain with target. The classic means for P to safeguard against hidden liabilities is to require warranties from the target shareholders and perhaps escrowing their stock. Neither is as effective as an asset acquisition.

i. **Use of warranties or escrow can also produce complex tax consequences at the T shareholder level.**

The T shareholders' preferred bargaining stance is to sell their T stock to P without warranties concerning T contingent liabilities. But if, as is likely to be the case, warranties would be required, they may prefer a T § 337 asset sale and § 331 liquidation due to the adverse tax treatment of any payment in a subsequent tax year (year 2) pursuant to the warranty. If Installment Reporting is not involved and the payment is made in year 2 either pursuant to the warranty (or as transferee of liquidated T if a § 337 "liquidating trust" for contingent claims is not utilized), the former T shareholder payments give rise to a capital loss (which may be of limited practical value if they have no capital gains in that or soon succeeding taxable years) under Arrowsmith v. Commissioner, supra. If Installment Reporting is involved, then the former T shareholder payment pursuant to warranty in a § 338 stock sale or as transferee in a § 337 asset sale and § 331 liquidation probably should be pro rated reducing future P payments under contingent payment provisions of the § 453 temporary regs. See III.D.4.c.iii.b. and f., supra. If, however, in a § 337 asset sale, T sets up a "liquidating" trust or partnership with assets to meet reasonable
contingent claims, the T shareholder will report only the net result from the trust, presumably in year 2. See authorities cited in III.B.2.c.i.a., supra. Still another discontinuity thus arises since such an approach is not possible with § 338. Lee, Taxable Corporate Acquisitions: A Transactional Analysis of Section 338, 9th Ala. Tax Inst. 3.1, 3.35 (1985).

ii. Does an Asset Acquisition Shed Unwanted Liabilities? Whether P actually can avoid hidden target liabilities by acquiring target assets is not clear. The emerging direction of corporate law, at least where a business line is acquired, whether in a C reorganization or by purchase at least as to product liability liabilities, is to treat such acquisition as a de facto merger with transferee liability to P as to the products liability exposure. See Phillips, Product Line Continuity and Successor Corporation Liability, 58 N.Y.U. L. Rev. 906 (1983).

D. Indirect Effect of Repeal on Section 1060.

Clearly the thrust of Section 1060 (in the Senate) was to attain parity between Section 337 and 338 as to allocation of basis and gain in cost basis corporate acquisition. Now Section 337 has been repealed and Section 337 will be little used. After the 2-year transition period for closely-held "small" corporations is over, most corporate acquisition will be carryover basis. How appropriate—a hasty, cobbled-together, down-and-dirty solution for a large non-problem. Its biggest impact probably will lie in the partnership arena. Still another reason not to elect Section 754. What should be provided is mandatory ordinary income treatment for going-concern value as to the seller and amortization over 60-months by the buyer.
Stock Purchases and the Section 338 Election

If the buyer is not successful in obtaining an asset purchase, Section 338 is currently available to the buyer to achieve results similar to an asset purchase. The use of Section 338, however, shifts the recapture tax liability from the seller to the buyer. While it is not the purpose of this article to relate an exhaustive analysis of Section 338, the mechanics of a Section 338 election are integral to a discussion of valuation of acquired assets.

Section 338 was enacted by Section 224(a) of the Tax Equity and Fiscal Responsibility Act of 1982 to remove perceived abuses by companies purchasing the stock of another company and desiring a "step-up" in the basis of the underlying assets. The primary abuses TEFRA sought to eliminate related to the ability under Section 334(b)(2) to offset recapture taxes with either the acquirer's or the acquired company's net operating loss or investment credit carryovers. Also, partial liquidations under Section 346 were being utilized to eliminate investment credit recapture and defer depreciation recapture in certain types of acquisitions. TEFRA repealed Section 334(b)(2) and Section 346 to curb these abuses and substituted Section 338.

Section 338 is generally elective and the technical requirements are very strict. A purchasing corporation must make a qualified stock purchase of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock (other than nonvoting preferred stock) within a 12-month period.

Special rules under Section 338(h)(3)(B) generally cause all 80 percent owned subsidiaries of the target corporation to be included in the Section 338 election. In addition, although no election is made, a deemed election may occur under operation of Section 338(e) where the purchasing corporation acquires certain assets of the target during a consistency period of about two years surrounding the election. The deemed election is intended to prevent the elective step-up in the basis of assets of the target company.

The Section 338 election is irrevocable and must be made within nine and one-half months after the date of acquisition. If the election is made or is deemed made, the target is deemed to have sold all of its assets under Section 337 on the date of acquisition. The 1984 Act amended original Section 338(h)(11) to provide that the deemed sale price for the underlying assets is the fair market value of the assets. Further, Section 338(h)(11) now specifies that "fair market value shall be determined on the basis of a formula provided in regulations by the Secretary which takes into account liabilities and other relevant items."

The temporary regulations which have been issued to date do not address the area of determination of fair market value or a number of other substantive areas. In fact, an election under Section 338 is not due until 60 days after publication of Reg. §1.338-4T (yet to be published).

Gain on the deemed sale is tested under Section 337 to determine recognition. Thus, items subject to recapture under Section 337 would result in taxable gain to the target. The tax year of the target ends on the date of acquisition, and any tax generated due to the application of Section 337 is due on that final return. If the target is included in the seller's consolidated return, then a separate return is filed including only recapture items. It is now clear that the tax liability on recapture items cannot be offset by either the buyer's or seller's tax attributes or carryovers and that the buyer is ultimately responsible for payment of the recapture taxes. The buyer does, however, receive additional basis in the acquired assets for the recapture taxes paid.

Since the purchaser must pay the relevant recapture taxes, the determination of items and related amounts of recapture tax is extremely difficult. For example, the effect of the deemed sale election on potential loss carryforwards is not yet clear.
important. As mentioned previously, the gain on the Section 338 election is tested under Section 337 for recognition. The following items are subject to potential recapture because of the deemed Section 337 treatment:

1. Recapture of depreciation on personal property under Section 1245.
2. Recapture of depreciation on real property under Section 1250.
3. Recapture of investment tax credit under Section 47.
4. Recapture of LIFO inventories under Section 337(f).
5. Recognition of deferred gain on installment obligations under Section 337(c).
6. Recognition of deferred DISC income.*
7. Recognition of income from controlled foreign subsidiaries under Section 1248.
8. Tax benefit items subject to inclusion in income for items previously deducted.

The basis calculation under Section 338 is at least a two-step process. The first step applies the fair market value of all assets against their respective tax bases to determine the tax on recapture items. The second step then allocates the adjusted purchase price (including recapture taxes) over the assets purchased based upon respective fair market values. The purchase price is adjusted by unsecured liabilities assumed and recapture taxes paid. An additional adjustment to the purchase price is required if less than 100 percent of the target is acquired.*

The methods of determining fair market values of specific tangible and intangible assets will be discussed in the remainder of this article as they apply to both Section 338 acquisitions and direct asset purchases. At this time it is appropriate to review the basis determination mechanics of the Section 338 election with a simple example.

**Facts:** P acquires 100 percent of T on December 1, 1984, for $1,600,000 and makes a Section 338 election. Sections 1245 and 1250 recapture equals $30,000; LIFO recapture equals $40,000; DISC recapture equals $30,000 (total tax related to those items = $150,000 × 50% or $75,000); and Investment credit recapture equals $25,000. T’s balance sheet on December 1, 1984, is as follows:

### Assets

<table>
<thead>
<tr>
<th>Asset</th>
<th>Tax Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Receivables (net)</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Inventories (LIFO)</td>
<td>150,000</td>
<td>225,000</td>
</tr>
<tr>
<td>Investments (including DISC)</td>
<td>70,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Fixed assets (net of depreciation of $110,000)</td>
<td>440,000</td>
<td>700,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>90,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Going concern value</td>
<td>0</td>
<td>400,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$870,000</strong></td>
<td><strong>$1,635,000</strong></td>
</tr>
</tbody>
</table>

### Liabilities

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>$180,000</td>
</tr>
<tr>
<td>Current taxes payable</td>
<td>20,000</td>
</tr>
<tr>
<td>Deferred taxes **</td>
<td>40,000</td>
</tr>
<tr>
<td>Stockholders' equity</td>
<td>530,000</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders’ equity</strong></td>
<td><strong>$870,000</strong></td>
</tr>
</tbody>
</table>

---

*The target corporation must include in its gross income, as a dividend, the excess of the fair market value of the DISC stock over its adjusted basis to the extent of the (deferred and untaxed) accumulated DISC income attributable to the stock held by the liquidating parent under Section 995(c)(2). See also Rev. Rul. 79-104, 1979-1 CB 263. This rather harsh treatment contrasts drastically with pre-1976 law, which allowed a target corporation owning a DISC to sell its DISC stock under Section 337 without recognizing the dividend income, so long as the purchaser corporation continued to operate the DISC. See S. Rep. No. 938, 94th Cong., 2d Sess. 299. Under the TRA of 1984, DISCs which are qualified on December 31, 1984 will treat all accumulated DISC income derived by a DISC prior to January 1, 1985 as previously taxed income. TRA of 1984, Sec. 805(b)(2)(A). In addition, no recapture will exist on transfers of FSC stock after 1984. Therefore, this recapture item is no longer of consequence for acquisitions after January 1, 1985.

**Section 338(c)(1) limits the nonrecognition provisions of Section 337 to the highest percentage of stock owned during the one-year period beginning on the acquisition date, unless the target is liquidated during that period. Thus, a tax liability could result in addition to recapture items due to the acquisition of less than 100 percent of the target’s stock. For ease of illustration, it will be assumed throughout the remainder of this article that the purchaser acquires 100 percent of the target.

**This rate is assumed to include the related state income taxes.

**No additional basis is available for deferred income taxes, as the liability exists only for financial accounting
The adjusted purchase price would be determined as follows:

P's cost of T's stock .......................... $1,300,000
Unsecured liabilities ................................ 200,000
Investment tax credit recapture ....................... 25,000
Tax on other recapture items ......................... 75,000

Total consideration paid ......................... $1,600,000
Less:
Cash .............................................. 20,000
Receivables .................................... 100,000

Basis to be allocated ......................... $1,480,000

The basis would be allocated as follows:

<table>
<thead>
<tr>
<th>Fair Market Value</th>
<th>Percentage</th>
<th>Allocated Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventories 225,000</td>
<td>14.9%</td>
<td>221,000</td>
</tr>
<tr>
<td>Investments (DISC) 100,000</td>
<td>6.6%</td>
<td>98,000</td>
</tr>
<tr>
<td>Fixed assets 700,000</td>
<td>46.2%</td>
<td>684,000</td>
</tr>
<tr>
<td>Other assets 90,000</td>
<td>5.9%</td>
<td>87,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>Going concern value 400,000</td>
<td>26.4%</td>
<td>390,000</td>
</tr>
</tbody>
</table>

$1,515,000 100% $1,480,000

The balance sheet before and after the election would then appear as follows:

**Assets**

<table>
<thead>
<tr>
<th></th>
<th>Before Election</th>
<th>After Election</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 20,000</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Receivables 100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Inventories 150,000</td>
<td>221,000</td>
<td></td>
</tr>
<tr>
<td>Investment 70,000</td>
<td>96,000</td>
<td></td>
</tr>
<tr>
<td>Fixed assets 440,000</td>
<td>684,000</td>
<td></td>
</tr>
<tr>
<td>Other assets 90,000</td>
<td>87,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill 0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Going concern value 0</td>
<td>390,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$870,000</td>
<td>$1,600,000</td>
</tr>
</tbody>
</table>

**Liabilities**

<table>
<thead>
<tr>
<th></th>
<th>Before Election</th>
<th>After Election</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and accrued expense</td>
<td>$180,000</td>
<td>$112,000</td>
</tr>
<tr>
<td>Current taxes payable</td>
<td>20,000</td>
<td>123,000</td>
</tr>
<tr>
<td>Deferred taxes 40,000</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Stockholders' equity 630,000</td>
<td>1,300,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total liabilities and shareholders' equity</strong></td>
<td>$870,000</td>
<td>$1,600,000</td>
</tr>
</tbody>
</table>

The holding period of all the assets of the target starts on the date after the acquisition date. The target corporation is deemed to be a new corporation for tax purposes and is therefore free to make new elections as to accounting methods, determination of amortization periods, choice of ACRS lives, etc.

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*Note: Text references not translated to markdown for clarity.*
Other Valuation Considerations

It is now an accepted fact of life that goodwill and going concern value should be considered and valued in every acquisition situation. Unless reasonable values are assigned to goodwill and going concern value, the ability to maintain allocations of value and subsequent amortization deductions is significantly jeopardized. Therefore, a discussion of the background of each concept and method available for valuation of goodwill and going concern value is critical for an understanding of the remainder of a discussion of other valuation considerations.

Goodwill.—“Goodwill” is a concept that arises in several areas of business, including tax law and financial accounting. It is a term that has been used so often and in so many different contexts that it eludes an easy definition. Before launching into a discussion of goodwill as it relates to the tax law, it may be helpful to first explore its meaning when used for accounting purposes in business acquisitions.

Accounting Principles Board Opinion No. 16, “Business Combinations,” requires that the acquisition of a business be accounted for either as a pooling of interests or as a purchase. Basically, a pooling of interests occurs when one corporation acquires another through an exchange of the stock of the purchaser for the stock of the target. Since the ownership of the stock of the target remains continuous (i.e., the shareholders of the target still have an interest in it through ownership of the stock of the merged corporation), the assets and liabilities of the target corporation are carried at book value on the books of the buyer corporation. The theory behind pooling of interests treatment is that the transaction is not a realization event since the owners have merely changed the form of their investment without severing their ties to it. This concept is similar to the treatment of a tax-free reorganization.

In contrast, other business combinations are considered to take the form of “purchases.” These are transactions in which a significant portion of the equity interests in the target corporation have been eliminated, as happens when a target is taken over by use of a cash tender offer or by use of debt securities which do not have equity characteristics and do not count toward continuity of interest. Since the ownership interests in the target corporation change, a realization event has occurred and the assets and liabilities of the target should be recorded at their fair market values. In many instances, the purchase price paid for the target will exceed the fair market values of the identifiable net assets. The excess represents “goodwill” for accounting purposes, and APB Opinion No. 17 requires that this goodwill be amortized over a period of not greater than 40 years. Goodwill will arise in the financial accounting sense, therefore, when an acquisition is accounted for as a purchase. Goodwill for financial purposes is defined in a mechanical way as simply being the excess of purchase price over the fair market value of identifiable assets.

In contrast to the financial accounting treatment of goodwill, tax law prohibits amortization since it is not considered to have a determinate useful life. Goodwill is a relatively old concept in the tax law, and one that has been the subject of much litigation. Definitions of goodwill have varied from case to case, but one frequently cited definition is “the sum total of those imponderable qualities which attract the customers of a business . . . the essence of goodwill is the expectancy of continued patronage, for whatever reason.”

The earlier cases in the development of the goodwill concept seemed to consider it as a catchall, or residual, of costs which could not be separately identified in a taxable acquisition. Later cases, however, have spoken of goodwill in terms of excess or extraordinary earning power. For example, one court defined goodwill as “the expectation of continuing excess earning capacity and some competitive advantage or continued patronage.” Goodwill had evolved to the point where it connoted extraordinary or unusual earning power. This evolution left something of a vacuum in the law which was filled by the judicial concept of “going concern value” in the 1960’s and 1970’s. Going concern value is an intangible asset which represents the ability of the business to generate income without interruption despite a change in ownership. Thus, goodwill has come to be identified with unusual earning power (compared with other businesses in that industry) while going concern value reflects the ability of the business to generate normal profits despite a change in ownership. Where excess earning power is shown to be associated with the personal attributes of an individual who is no longer with the enterprise after transfer, courts have held that no goodwill was transferred. Similarly, where price competition is intense, goodwill may arguably not exist since recurring customer contacts result...
from price and not from any special attributes of the business.47

While many courts have struggled with the definition of goodwill, measuring it has proven to be even more difficult. The three basic approaches courts have used are the residual method, the contract method, and the formula method.48 The residual method is similar to the means of computing goodwill under generally accepted accounting principles (the purchase method). That is, goodwill is the difference between the purchase price of the business and the fair market values of the identifiable assets.

Under the contract method, the buyer and seller agree between themselves as to the value to be placed on goodwill. Assuming that the parties are "adverse" in the tax sense (i.e., that the seller would be better off with capital gain treatment and the buyer would be better off with an amortizable asset) the IRS and the courts will generally not upset their allocation.

The formula method was first set forth by the IRS in A. R. M. 34, and is also known as the "A. R. M. 34 method."49 This method was updated and approved by the IRS only for use in situations where there is no better basis for measuring goodwill.60 The formula approach attempts to capitalize the excess earning power of the business. The formula approach is rather complex but, in essence, a percentage return on the average annual value of the tangible assets used in a business is determined using a period of at least five years immediately prior to the valuation date. The amount of the percentage return on tangible assets thus determined is deducted from the average earnings of the business for the period. The remainder is considered to be the amount of the average annual earnings from the intangible assets for the period. This amount, when capitalized, is the value of the unidentified intangibles under the formula approach. The ruling recommends a 15 percent rate of capitalization for business with low risk and a rate of 20 percent for businesses with a higher risk of failure. Likewise, the percentage rate of return on tangible assets used in a low-risk business is set at 8 percent, and at 10 percent for a high-risk business.

All three methods of valuing goodwill have been applied by the courts, although the residual method seems to appear most frequently, perhaps because of its simplicity.41

Going Concern Value. — The concept of going concern value originated in regulated industries rate cases in the 1910's.42 The concept gained vitality in the 1970's in a series of purchase price allocation cases when the IRS argued that the purchasers acquired going concern value in those cases where goodwill was not found to exist.43

The accepted definition of going concern value in most of the cases is "in essence, the additional element of value which attaches to property by reason of its existence as an integral part of a going concern."44 One frequently cited case involving going concern value is VGS Corporation v. Commissioner.45 VGS was a corporation whose predecessor acquired all the stock of a corporation and certain assets of a partnership which were operated together as a going concern. The acquired corporation was subsequently liquidated under Section 332, with basis determined under Section 334(b)(2). The parties relied on an appraisal report to allocate the purchase price over the assets acquired but did not allocate any value to intangibles, such as goodwill or going concern value.

The court found that no goodwill was transferred, since the existence of goodwill would require that the "purchaser could expect not only continued excess earning capacity, but also some competitive advantage or continued patronage."46 Application of the capitalized net earnings method demonstrated that there was no excess earning capacity in the business. However, the court did find that going concern value existed because the "operations were able to survive and make a profit in a highly competitive industry during a time when many small refineries were unable to break even . . . . The business acquired . . . was more than a mere collection of assets. It was rather a viable, functioning, and going concern capable of generating a profit, and (the buyer) acquired a valuable property as a result."47 The court measured the going concern value by using a combination of the taxpayer's and the IRS's appraisal reports. As a result, costs allocated to each asset group in the taxpayer's original appraisal were adjusted to reflect the going concern value of each such asset group. The depreciable bases of the tangible assets were reduced, and an intangible asset was correspondingly established. Since going concern value has an indeterminate useful life, it (like goodwill) was not subject to the allowance for amortization.

VGS illustrates a number of issues important in the going concern area. For example, the court in VGS clearly differentiated between goodwill and going concern value. Some courts, however, have found it sufficient merely to decide that goodwill or going concern value exist. Having made that determination, these courts have not taken the further step of allocating between the two since the result is the same regardless of

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47 See VGS Corporation, note 55, supra.
48 For discussions on valuation of goodwill, see Donaldson, note 49, supra, at 296; 4 Mertens Section 59.29 and following (Callaghan & Company, 1976).
49 2 CB 31 (1920).
51 See e.g., Jack Daniel Distillery v. U. S., note 21, supra.
53 See e.g., VGS Corporation, note 55, supra; Computing & Software, Inc., CCH Dec. 33,721, 64 TC 223 (1975).
54 VGS Corporation, note 55, supra, at 591.
55 Note 53, supra.
56 Id. at 590.
57 Id. at 592.
how the intangibles are designated. Current cases have clearly analyzed going concern value and goodwill as distinct assets and have recognized that they may exist independently of each other. Therefore, in planning an acquisition, both assets should be considered separately.

The proper method of determining the value of going concern is obviously the most important issue. The court in VGS applied a combination of appraisals to arrive at going concern value. In contrast, the Tax Court in Black Industries, Inc. applied the residual method to determine going concern value. In Black Industries, the court first ascertained the fair market values of the tangible assets acquired by using appraisals. Finally, the court subtracted this sum of fair market values from the total purchase price to arrive at going concern value using the residual method. In contrast, the court in Concord Control, Inc. v. Commissioner applied the capitalization method to determine going concern value. The court rejected use of the residual method because it was not confident in the appraised values of the tangible assets. The capitalization method was thus found to produce the most accurate and reasonable estimate of going concern value.

The above methods of valuation correspond to the methods previously discussed with regard to the valuation of goodwill. One method discussed in that regard is the “contract method,” whereby the parties (buyer and seller) may agree on the value attached to going concern value. The taxpayer in such a case may argue that the purchase agreement allocates going concern value and is not subject to attack by the IRS. In Concord Control, Inc., for example, the parties attempted to allocate $1 to all intangible assets in their purchase contract. The court found that the parties were not adverse in a tax sense because the seller had no gain to recognize due to net operating loss carryforwards. In Concord Control, Inc., the contract method of valuation did not apply since the court did not respect the allocations made by the parties.

Tax Benefit Rule.—One of the greatest hazards in taxable acquisitions is the application of the tax benefit rule. Although the tax benefit rule is not a new concept, recent court decisions have clarified its application. Where Section 338 is elected following a stock purchase, the acquirer should be aware of the potential for application of this rule as its effect could be very detrimental to the economics of the acquisition. In the situation of a purchase of assets, the effect of the application of the tax benefit rule rests with the seller. A knowledgeable seller, however, will anticipate the hazards of the tax benefit rule and therefore will negotiate the sales contract with the potential cost of its application in mind. For example, if a buyer desires to allocate a specific part of the purchase price to an asset created out of research and development outlays, the seller may demand compensation for the imposition of ordinary rates instead of capital gain rates on any gain.

The tax benefit rule has been judicially developed over the years with various refinements and distinctions. Dobson v. Commissioner involved a taxpayer who sold stock at a loss, which resulted in a deduction on the return for the year in which the stock was sold. In a later year the taxpayer recovered an amount from the settlement of a suit against the seller of the stock. The Court found the amounts recovered were not taxable gain except to the extent that the loss deduction of the prior year resulted in a tax benefit. Dobson stands for the proposition that the tax benefit rule applies to an actual recovery of losses taken in prior years.

Besides Dobson, there have been a number of cases expanding or narrowing the application of the tax benefit rule. In Commissioner v. South Lake Farms, Inc., the court held that farming expenses incurred in the production of unharvested crops which were deducted in one taxable year were not includable in income the following year when the farm corporation was liquidated under Section 336. The court explained that Dobson limited the tax benefit rule to actual recoveries. The court concluded that it did not see any theory on which it could be said that the liquidated corporation had recovered the expenses of production that it deducted. Thus, there was no amount to be included in income.

In Tennessee-Carolina Transportation, Inc. v. Commissioner, the Sixth Circuit rejected the holdings in the above cases. In this case a subsidiary prior to its liquidation under Section 332 had fully expensed the value of its tires and tubes. Under Section 334(b)(2) the parent claimed a stepped-up basis in the tires and tubes acquired. The court held that the parent was required to include in income the value of the tires and tubes distributed to it by its subsidiary. Under Section 334(b)(2) the parent claimed a stepped-up basis in the tires and tubes acquired. The court held that the parent was required to include in income the value of the tires and tubes distributed to it by its subsidiary. First, the court held that the tax benefit rule is applicable to corporate liquidations under Section 336. Second, the court held that there was no need for an actual physical “recovery” of some tangible asset or sum in order to apply the tax benefit rule. The court cited Block v. Commissioner for the proposition that the tax benefit rule should apply whenever there is an actual recovery or an event inconsistent with the prior deduction. The court in Tennessee-Carolina Transportation found the liquidation of the subsidiary inconsistent with the prior deduction.

*See e.g., Computing & Software, Inc., note 63, supra; Winn-Dixie Montgomery, Inc. v. U. S., 71-1 ustc ¶ 9488, 444 F. 2d 677 (CA-5).
*See e.g., Solitron Devices, Inc., CCH Dec. 39,801, 80 TC 1 (1983).
*See note 18, supra.
*80-1 usuc ¶ 9248, 613 F. 2d 1153 (CA-6).
*See e.g., Concord Control, Inc. v. Commissioner, note 71, supra.
*44-1 usuc ¶ 9108, 370 U. S. 489 (1943).
*61-1 usuc ¶ 9101, 324 F. 2d 837 (CA-9 1963).
*78-2 usuc ¶ 9671, 582 F. 2d 378 (CA-6), cert. denied, 440 U. S. 909 (1979).
*40-1 usuc ¶ 9273, 111 F. 2d 60, aff'g CCH Dec. 10,585, 39 BTA 338, cert. denied, 311 U. S. 658.

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The most recent cases addressing the tax benefit rule were the companion cases of Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc. In Hillsboro the corporation (a bank) made payments for state taxes imposed on their shareholders and then deducted the amounts paid. The state ultimately refunded the amounts to the shareholders. The court found that the payments made by the corporation were not negated since there was no refund to the corporation, and thus the refund to the shareholders did not require the corporation to recognize income under the tax benefit rule.

In Bliss Dairy, the court did apply the tax benefit rule so that the taxpayer (a farm corporation) was required to recognize income. In Bliss Dairy the corporation deducted the full cost of cattle feed purchased for use in its operations. The following taxable year the corporation liquidated pursuant to Internal Revenue Code Section 336 and distributed its assets including the cattle feed to its shareholders. Since Section 336 shields a corporation from recognizing gain on the distribution of property to shareholders, the corporation reported no income on the transaction. The shareholders presumably took a basis greater than zero in the feed.

The court recognized that a concern for a more accurate measurement of income underlies the tax benefit rule. The court declined to follow the "recovery" analysis of South Lake Farms and other cases as the exclusive approach to the tax benefit rule. In discussing the purpose of the tax benefit rule, the court stated that the tax benefit rule will "cancel out" the prior deduction only if a later event is fundamentally inconsistent with the assumptions on which the deduction was based. In other words, if the event occurred in the same taxable year, the deduction would not have been allowed. In Bliss Dairy the court found such a fundamentally inconsistent event. When the deduction for the cost of the cattle feed was made, the corporation assumed it would be consumed within the taxable year; it was not. The shareholders received it in the following year and obtained a step-up basis.

Thus, only where an event occurs that would have resulted in a disallowance of the deduction had it occurred in the earlier year must the taxpayer recognize income when the event occurs in a later year. The taxpayer's proper action is to include the amount in the later year's income rather than file an amended return. This is especially true if the statute of limitations has run and the filing of an amended return is precluded.

Bliss Dairy significantly widens the application of the tax benefit rule. Justice Stevens in his dissent stated that "[p]resumably all expenses for the purchase of tangible supplies will be treated like cattle feed. Thus, all corporate paper towels, paper clips, and pencils that remain on hand will become income as a result of the liquidation." Because Bliss Dairy involved a liquidation in which gain was not recognized, the issue is raised as to whether specific nonrecognition provisions prevail over the tax benefit rule. Bliss Dairy involved the nonrecognition provisions of Section 336. The court concluded that Section 336 did not prevent the application of the tax benefit rule. The nonrecognition provisions of Section 336 are not absolute. For example, Section 336 does not bar Sections 1245 and 1250 recapture of excess depreciation taken on distributed assets. The court, citing a number of cases, concluded that the courts have never read Section 336 as absolute.

The court also likened Section 336 to Section 337 in stating that the very purpose of Section 337 was to create the same consequences as Section 336. The court then stated that "the rule is now well established that the tax benefit rule overrides the nonrecognition provisions" of Section 337. Thus, as Section 336 is similar to Section 337 and Section 337 is overridden by the tax benefit rule, then Section 336 is also overridden by the tax benefit rule.

Based upon the Bliss Dairy decision, it seems clear that the tax benefit rule could apply where Section 336 is elected because of Section 338 reliance on the rules of Section 337 for guidance as to taxability of the target corporation.

Application of the Tax Benefit Rule.—The tax benefit rule works to include in income the amount previously deducted to the extent of the value of the particular item. This means that if, for example, $25 was previously deducted relative to a particular asset which was worth $50 at the time of acquisition or liquidation, the tax benefit rule would apply only to the $25 previously deducted. Therefore, a determination as to both current value and historical costs must be made in order to assess the effect of the tax benefit rule. While both determinations may be difficult, the determination of historical cost in many circumstances can be especially troublesome, as many accounting systems do not provide for easy accumulation of costs of specific items that are expensed. It is likely, therefore, unless it can be shown to the contrary that the previously expensed amount was less than the value of the asset, that the IRS would take the position that the cost equalled or exceeded the value assigned.

When the cost of an item that can be subsequently expensed or amortized is readily determinable and the value to be assigned exceeds that cost significantly, an opportunity still exists for a favorable purchase price allocation. The cost of the tax benefit recapture must, of course, be balanced against subsequent tax deductions from the asset.

1 Id., 103 S. Ct. at 1162.
2 Sections 1245(b)(3), 1250(d)(3).
3 See note 78, supra, 103 S. Ct. at 1151.
4 Id. at 1153.
5 See CCH IRS LETTER RULINGS REPORTS No. 366, Part II (Nov. 23, 1983), PLR 8409009.
It is not known yet whether the IRS will attempt to apply Justice Stevens’s theory in his Bliss Dairy dissent to all pencils, paper clips, etc., of an acquired company. Finally, the fact that a purchaser does value items which are subject to the tax benefit rule would not preclude the IRS from asserting a value to be assigned and thus causing additional tax liabilities.

Inventories.—Valuation of inventories is a significant factor in most acquired businesses. In lines of business where the gross profit derived from inventories is relatively high, an opportunity exists to assign a significant premium paid over book value to inventories acquired.

Revenue Procedure 77-12 sets forth guidelines for making fair market value determinations in asset purchase situations and where Section 338 is elected. The revenue procedure authorizes the use of any of the three basic methods to determine the fair market value of inventory: (1) the cost of reproduction method, (2) the comparative sales method, and (3) the income method.

The cost of reproduction method is most appropriate for use in valuing inventories in wholesale and retail businesses, but should not be used to establish the fair market value of the finished goods of a manufacturing concern. This method generally refers to replacement cost of inventory items. The revenue procedure also allows a value to be assigned based upon having a well-balanced stock in place to serve customer needs.

The comparative sales method utilizes the actual or expected selling prices of finished goods to customers as a basis of assigning fair market values to those finished goods. The revenue procedure specifies that certain costs should be deducted from the expected sales price, including all costs of disposition, which includes applicable discounts, sales commissions, and freight and shipping charges. In addition, allowance should be made for a reasonable profit margin on the amount invested in the inventory. The reasonable profit margin should consider the length of time required to dispose of the inventory and the degree of risk associated with the business. Work in process may also be valued using this method by adding the costs of completion to the value of the finished goods.

The income method is very similar to the comparative sales method, although this method focuses on providing a stream of income to provide for continuation of the acquired business. Return on investment and costs of distribution are also considered in applying this method.

To illustrate how the use of the comparative sales method may be beneficial, assume that P acquires the assets of T. Included in T’s assets are inventories which have a basis of $400 and a retail value of $800. The disposition costs, including freight and sales commissions, are $80. It is also determined that T’s inventory turns over an average four times a year, so, on average, the inventory could be expected to be sold within three months. Further, T has experienced a 4 percent rate of obsolescence on an annual basis.

P’s investment rate of return is assumed to be 12 percent. The value to be assigned would be computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected sales price</td>
<td>$800</td>
</tr>
<tr>
<td>Cost of disposition</td>
<td>(80)</td>
</tr>
<tr>
<td>Return on investment</td>
<td></td>
</tr>
<tr>
<td>Investment rate</td>
<td>12%</td>
</tr>
<tr>
<td>Risk factor</td>
<td>4%</td>
</tr>
<tr>
<td>Annual return</td>
<td>16%</td>
</tr>
<tr>
<td>Divided by turnover rates (4 times)</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>4%</td>
</tr>
<tr>
<td>Expected return x net value ($720 x 4%)</td>
<td>(29)</td>
</tr>
<tr>
<td>Fair market value</td>
<td>$691</td>
</tr>
<tr>
<td>T’s basis</td>
<td>400</td>
</tr>
<tr>
<td>Increase</td>
<td>$291</td>
</tr>
</tbody>
</table>

The comparative sales method is very similar to the method prescribed for acquisitions covered by APB 16 for financial statement purposes. One strategy frequently employed in the use of this method is to adopt the first in, first out (FIFO) method of accounting for inventory valuation for the first taxable year after the acquisition in order to recover benefit of the allocation. Adoption of the last in, first out method, if favorable, is then deferred until the second tax year to avoid locking in the excess cost allocation to inventory.

Valuation and Amortization of Intangible Assets.—In order to sustain the valuation and subsequent amortization of an intangible asset, it is necessary to separate the value of that intangible from goodwill and going concern value. Regulation § 1.167(a)-3 describes the amortization of intangible assets. The basic requirements in the regulations are that the asset must be of use in the business for a limited period, and that the period can be estimated with reasonable accuracy. Revenue Ruling 74-456 adds the requirements that the intangible asset must not be a part of goodwill and, in addition, must have a separate ascertainable value.

The IRS has, in a number of cases, resisted attempts by the taxpayer to amortize intangible assets by raising the "mass asset" theory. Un-
nder this theory, intangible assets are valued as an inseparable part of goodwill and therefore not subject to amortization. The mass asset theory has been described as the purchase of a “collection of inextricably intertwined, intangible assets or rights whose values are so interrelated and interdependent that they are not capable of separate valuation other than in an unacceptable, arbitrary manner. Further, each particular right does not diminish with the passage of time. To put it another way, the value of the mass of acquired assets does not lie in its individual components but in the whole indivisible bundle.”

The IRS successfully applied the mass asset theory in *Boe v. Commissioner.* In Boe, the taxpayer was one of four partners who purchased a contract medical service organization, the major asset consisting of several thousand medical service contracts to provide services to subscribers. Some of the purchase price was allocated in the purchase contract to tangible assets, with the bulk of the price being allocated to “goodwill and other assets.” The purchaser later attempted to specifically allocate part of the purchase price to the medical contracts and to deduct them as they expired. This attempt was rejected by the court.

In *First Northwest Industries, Inc.*** the taxpayer attempted to assign costs to player contracts acquired in connection with the purchase of a professional basketball franchise, the Seattle Supersonics. The IRS argued that the contracts were part of a nonamortizable mass asset. In so arguing, the IRS offered the following indicia of a mass asset: "(1) The mass includes intangibles of indefinite duration which provide the means to replace those individual intangibles that are likely to expire, thus regenerating the value of the mass as an entity; (2) the intangibles of indefinite duration are relatively more significant in value than parts of the mass which may expire; and (3) the intangibles that do expire derive their value, and have no value separate and apart, from the assets of indefinite duration." The key to a mass asset seems to be indefinite useful life of the bulk of the intangibles and the inability by the taxpayer to separate truly amortizable intangibles from the bulk of the intangibles which have an indefinite useful life, such as goodwill.

The earlier cases analyzed intangibles under the mass asset theory, with the bulk of intangible assets purchased having an indeterminate useful life. More recent cases have looked on the mass asset theory as more of a default position in which the taxpayer has failed to sustain its burden of proof that the intangibles have a separate value and a determinable useful life. One relatively recent case, *Houston Chronicle Publishing Co. v. U. S.* reflects a more analytical approach than the monolithic mass asset theory espoused by the IRS.

In *Houston Chronicle,* the taxpayer was a newspaper publisher who purchased the assets of a rival newspaper, including various tangible assets, a subscription list, and an agreement from the seller not to publish a newspaper in the same vicinity for a period of 10 years. The taxpayer paid the seller a total of $4,500,000, none of which was allocated to the various assets in the purchase agreement. The taxpayer engaged in a post-acquisition valuation of the assets purchased, including the subscription lists. The lists were valued by approximating the circulation of the defunct newspaper and by estimating the percentage of old subscribers who would be expected to subscribe to the *Houston Chronicle in order to determine the anticipated number of new subscribers.* The anticipated number of new subscribers was extended by the average cost of obtaining a new subscriber to arrive at a value for the lists. Finally, the taxpayer did not consider the lists to be self-regenerating since the buyer discontinued publication of the seller’s newspaper.

The lump-sum purchase price in *Houston Chronicle* did not reflect a specific allocation of costs to the various assets, including the subscription list. However, the court would not acquiesce to the simplistic mass asset theory as a reflex action to the absence of an allocation. Rather, the court analyzed the situation in terms of the burden of proof required to overcome the IRS’s proposed deficiency.

The court noted that the taxpayer has the burden of establishing its right to claim a depreciation deduction under Section 167(a). In cases where the taxpayer has failed to carry his burden, it was because of a failure of proof, rather than a finding that the asset involved is nonamortizable per se. The court held that *Houston Chronicle* sustained its burden of proof because of the following items offered as evidence of valuation and useful life:

1. Testimony from taxpayer’s officers and employees, based upon their experience as publishers of an afternoon newspaper in the Houston area, regarding the cost of obtaining new subscriptions;
2. Corroborative testimony from the valuation engineers;
3. Testimony from taxpayer’s officers and employees regarding the anticipated useful life of a subscription list used in connection with the publication of an afternoon newspaper in the Houston area;
4. Corroborative testimony from the valuation engineers as to useful life; and
5. The results of a survey of current subscribers regarding the useful life of an average subscription, and testimony connecting

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**First Northwest Industries, Inc.,** CCH Dec. 35,384, 70 TC 817, 844 (1978), rev’d and rem’d on different grounds, 81-2 ustc ¶9529, 649 F. 2d 707 (CA-9).

**See note 52, supra.**

**See note 58, supra.**

**1d., 70 TC at 845.**

**See note 87, supra.**

**73-2 ustc ¶9537, 481 F. 2d 1240 (CA-5).**
the survey with the acquired subscription lists (i.e., testimony that conditions in the afternoon newspaper market in Houston had not materially altered in the years in question).**

The above criteria would seem to be relevant to the establishment of value and useful life of many intangible assets that can be separated from goodwill and going concern value. The following discussion of specific intangible assets is predicated upon, first, the establishment of appropriate valuation of goodwill and going concern and, second, the existence of evidence such as in Houston Chronicle which could be used to support determinations of value and useful life.

Core Deposit Premiums.—One intangible which has received considerable attention recently due to the number of acquisitions of financial institutions is core deposit value. Core deposit value, in a nutshell, is the value to a financial institution of the spread between rates paid on customer deposits and the rates earned on loans and other investments in which those deposits are reinvested. For example, if an acquired institution has deposits of $100,000,000 on which it pays an average of 8 percent and is able to reinvest those deposits at an average rate of 12 percent, the 4 percent spread in rates is a valuable asset acquired with the deposits.

In order to determine core deposit value in an acquired institution, the various categories of deposits are analyzed to determine the total costs allocable to each category of account. For example, passbook deposit costs are the interest paid on the deposits and the cost to service the accounts. After the total cost for all deposit accounts is calculated, an alternative fund investment rate is then determined based upon what the acquiring bank would pay for similar deposits. Based upon this difference, an amount may then be computed to be allocated to core deposit value.

Finally, it is necessary to determine useful life in order to recover the value over some period. The approach most frequently used is based upon historical turnover of the acquired bank's customer accounts. Thus, for example, if the acquired bank averaged 10,000 customer deposit accounts over a five-year period and also averaged 1,000 closed accounts per year over the same period, the useful life of the deposit base could be determined to be 10 years. Care should be exercised in this objective determination that the historical data is representative of future account relationships. The effect of deregulation and increased competition in the future may significantly increase the turnover of deposit accounts as well as increase the cost of the acquired funds.

Two recent cases are key to the core deposit valuation area. In Midlantic National Bank,** the taxpayer purchased the right to solicit the customers of an insolvent bank. The court held that no part of the amount paid was allocable to goodwill because Midlantic had no reasonable expectation of attracting the goodwill of customers of the insolvent bank, as many customers suffered loss due to embezzlement by the officers of the insolvent bank. Further, none of the purchase price was attributable to going concern value since the insolvent bank was closed.

The court analogized the acquisition of the seller bank's core deposits to the acquisition of customer lists in Manhattan Company of Virginia, Inc.,** since the acquisition was one of the core deposits unaccompanied by goodwill or going concern value. The court determined that 90 percent of the acquisition price was allocable to the core deposit premium and allowed amortization over 14 years on the factual finding that between 10 and 15 percent of the accounts closed each year. The remaining 10 percent of the cost of the right to solicit accounts from the acquired bank was nonamortizable since that amount represented the longevity of larger accounts and the indefinite nature of their lives.

The recently decided case of Southern Bancorporation, Inc. v. U. S.,** sheds further light on the amortization of core deposit premium. Southern Bancorporation (SBC) acquired assets of a failing bank in a Federal Deposit Insurance Corporation initiated merger. Although the excess purchase price was not specifically allocated to particular assets at the time of the merger, on its tax return SBC allocated a large part of the excess purchase price to the loan portfolio of the former bank and a small portion to going concern value. The excess purchase price was allocated to loans based on credit risks and yields and resulted in a $5 million increase in the face amount of the loan portfolio. The premium was then amortized over the remaining lives of the respective loans. The District Court agreed with SBC's allocation.

The Fourth Circuit Court of Appeals reversed the lower court decision, determining that there was no indication at the time of the acquisition that the loan portfolio was being sold for an amount that would have been paid by a willing buyer and seller in an arm's-length sale. The court held that the purchase price premium should be allocated to going concern value since SBC would continue the operation of the acquired bank in the same location with its own branch. Importantly, however, the court, in a footnote, discussed the possibility of establishing an amortizable deposit base and cited Midlantic.*** Although SBC did, raise the issue in its complaint, it did not pursue a deposit base allocation during the trial and the court did not make such allocation.

In response to Midlantic, the IRS announced in a 1984 Action on Decision**** that it would ac-
quiesce in the Midlantic decision for acquisitions of failing banks, but will strongly oppose any attempt to create an amortizable useful life for the costs incurred to acquire a pre-existing deposit base of a going concern bank which has been acquired. Banks should expect a challenge to any deduction resulting from the amortization of costs allocated to the acquisition of a pre-existing deposit base of an ongoing bank, as a result of taxable asset acquisitions or Section 338 elections.

Based upon these decisions and in spite of IRS opposition, it appears that core deposit value is a viable intangible asset that should be considered in acquisition of financial institutions. Although the above cases dealt only with failed banks, the same principles should apply to acquisitions of "healthy" institutions if proper determinations of goodwill and going concern value are made.

Covenants Not to Compete.—Due to the tax consequences, a strong dichotomy of interests between buyers and sellers has developed over the years concerning the allocation of costs between goodwill and covenants not to compete. The seller is interested in having as much of the purchase price as possible allocated to goodwill, as opposed to a covenant not to compete, so that the sale proceeds may qualify for capital gain treatment. If the purchase price is allocated to the covenant, the payments received by the seller are treated as ordinary income. The buyer is interested in the converse, namely, having as much as possible allocated to the covenant so that he may amortize the cost of the covenant over its lifetime. If the purchase price is allocated to goodwill, an asset with an indeterminable life, the buyer will not be afforded an amortization deduction.

Courts generally will not allow the parties to an agreement to disturb the express allocations to goodwill and covenants not to compete, as previously discussed. Where a written agreement makes no allocation of the lump-sum purchase price to a covenant not to compete, the courts, in rare instances, have allowed the purchaser to successfully challenge the allocation, thus entitling him to amortize the covenant during its lifetime. In order for the buyer to prevail in such a dispute, the Tax Court has held that he must be able to show: "(1) that the covenant had independent economic significance such that we might conclude that it was a bargained-for element of the agreement; and (2) that the parties considered the covenant as a valuable part of the entire consideration of the agreement."100 In Illinois Cereal Mills, the buyer was able to meet this difficult burden of proof. In that case, the purchase agreement expressly provided for a covenant not to compete but did not make any allocation of the purchase price for that or any other asset. The court stated that it was clear that the covenant had significant independent economic value because, absent the covenant, there was nothing to prevent the seller from re-entering the same market in the future if economic changes suggested increased profitability. As to the second requirement, the court stated that, based on the parties' own testimony as well as their actions, both the buyer and the seller considered the covenant a valuable part of the total consideration. Hence, the court found that 20 percent of the total purchase price was properly allocable to the covenant not to compete, that amount being subject to amortization deductions over the five-year life of the covenant.

Finally, it is clear that where no covenant was bargained for in a purchase agreement (absent facts similar to Illinois Cereal Mills), the courts will not sustain allocation of value to covenants not to compete.101

Favorable Leases and Contracts.—The existence of favorable leases in a target company which are assumable by the purchaser can offer significant opportunities for assignment of value. The fair market value of a particular lease may be determined by reference to similar leases for the same or similar property. This valuation technique may be especially valuable for leases of real estate and office space and in some cases equipment such as aircraft that have appreciated in value since the lease originated. The excess value determined by the difference between current lease rates for the same property and the contractual lease rates can be assigned a value. Since the lease has a definable value and the life is known, this value may be amortized over the life of the underlying lease.102

The Tax Court and the Sixth Circuit in Miami Valley Broadcasting Corp. v. Commissioner 103 approved a method for valuation of acquired leases. Miami Valley bought all the stock in a television station and thereafter liquidated it. As part of the liquidation, Miami Valley received a lease with a 14-year remaining term. Although its only use was as a television facility, the lease was considered a premium lease, as the rental payments were only $26,200 per year, whereas the annual fair market value rent for the building and its underlying land was $94,200. The difference between the actual rent to be paid over the remaining 14-year term of the lease and the fair market rental for the same period was $957,667. In view of this differential and the absence of any actual market for the lease, the Tax Court determined that the proper method for valuation of the leasehold was the income approach.

83-2 U.S.C. § 9630, 571 F. Supp. § 16 (DC Mich.) (deduction for amortization of a covenant not to compete discharged where no value assigned to covenant at the time of the acquisition).

102 See e.g., Washington Package Store, Inc., CCH Dec. 27,041(M), 23 TCM 1805 (1994).

103 83-2 U.S.C. § 9747, 661 F. 2d 582 (CA-4), rev'd and rem'g CCH Dec. 36,506(M), 39 TCM 760 (1979) (Sixth Circuit agreed with method of valuation of Tax Court, but remanded for redetermination based on higher interest rate).
The court explained that under that approach it is necessary to ascertain or estimate the present value of the anticipated savings in rent over the following 14-year period of ownership of the lease. To compute the present value of the excess of the economic rent over the contract rent, an appropriate discount factor must be applied to the future income (the anticipated savings in rent in this case). The discount factor must reflect the hazards of the investment such as the inherent risks that business or economic conditions may change over the period of the lease, the practical problems of marketing the lease or otherwise liquidating the anticipated savings at any given times, and the burdens and limitations imposed by the terms of the lease.

The Tax Court calculated a present value of the anticipated savings in rent over the following 14-year period of $350,000 by using a discount rate of 17 1/2 percent, which was composed of a 12 1/2 percent interest rate plus 5 percent for investment risks. On appeal, the U. S. Court of Appeals, Sixth Circuit, reversed and remanded the case to the Tax Court with instructions that the Tax Court conclude the matter by determining the value of the leasehold in question using a discount rate of 11 percent. The Court of Appeals arrived at this 11 percent figure by taking the prevailing interest rate at the time the present value of the leasehold in question was to be determined (6 percent in 1964) and adding to it an additional 5 percent to reflect the investment risks determined by the Tax Court.

It would seem that similar methods may be used to value favorable contracts for either the purchase or sale of goods, again assuming the purchaser is able to assume the target's rights under the contracts. For example, the target may have long-term supply contracts for raw materials that are negotiated at a time where raw material prices were lower than current prices. The additional value of the contract based upon increased raw material prices could be amortized over the remaining life of the contract.

Liabilities.—To the extent liabilities are assumed that have rates or terms that are below current market rates, a positive value may be assigned to this “asset.” This frequently occurs where the target has incurred long-term debt at rates below current market rates. This value can be measured by the difference in the rates and amortized over the life of the debt issue.

Patents, Nonpatented Technology, Trademarks, Trade Names and Franchises, etc.—Since the value of a particular patent, nonpatented technology or trademark, etc., is unique to the owner of that item, valuation by reference to the net income generated by the asset is probably the most appropriate method. If the asset is licensed to a third party, calculation of the value may be made by reference to the income generated by the licenses or royalties after allowing for all costs related to the collection of the license or royalty income. If, on the other hand, the intangible asset is used in the target’s business, the net income from the sale of products associated with the intangible assets should be calculated. The stream of income thus determined should be discounted to calculate a net present value assignable to the intangible asset.

Amortization for amounts assigned to patents would be based upon the remaining patent life. Amortization of values assigned to nonpatented technology is more difficult as there is no fixed period of usefulness. In order to claim amortization on amounts allocated to nonpatented technology, the taxpayer would have to be prepared to show that the technology would become obsolete or of no further use after a certain period of time.

Nonpatented technology exists quite frequently in manufacturing companies. Essentially, it is valuable technology or “know how” that cannot be patented or a decision has been made not to apply for a patent on the particular process. The tax benefit rule should always be considered when identifying potential technologies for valuation as it is likely the cost to develop the process has been expended previously and may therefore be recaptured under the tax benefit rule.

Contingent Purchase Price Considerations

It is quite common for acquisitions to be structured with some part of the purchase price contingent upon a variety of events. Most contingencies relate to the achievement of significant assumptions built into the buyer’s purchase rationale, such as achievement of certain levels of sales, profitability or return on investment. These contingent payments are generally structured as “insurance” to the buyer, such that if certain goals are not met, his purchase price is not adversely affected.

Whenever some part of the purchase price is contingent and payable more than one year from the date of sale, Section 483 must be considered. Section 483(b), as amended by the Tax Reform Act of 1984, provides for imputed interest where the stated interest on the future payments is less than 110 percent of the applicable federal rate determined under Section 1274(d). Section 483(d)(4) excludes contingent payments related to patents from the application of the imputed interest rules.

The effect of the imputed interest rules is generally favorable to the buyer. To the extent that a portion of a future payment is determined to be imputed interest, the buyer receives an interest deduction at the time of payment. The remainder of the payment must then be analyzed to determine what the tax treatment is at that future date.


See e.g., Illinois Cereal Mills, Inc. v. Commissioner, note 4, supra, 46 TCM at 1022.

TRA of 1984, Section 41(b).
In an asset purchase where the buyer and seller have agreed to the allocation of the purchase price among the various assets, a contingent payment may be related to a specific asset. Also, where a contingent payment is based upon income from a certain asset, such as a patent or trademark, the allocation can be made directly. On the other hand, where no agreement exists between buyer and seller as to allocation of the purchase price, it is possible the IRS may assert the contingent consideration is additional goodwill. This would especially be true where goodwill or going concern value are determined under the residual method, as discussed above. It is therefore very important that the purchase contract relate contingent payments to specific assets being acquired.

The tax treatment of contingent payments to the purchaser varies with the underlying asset to which it is ultimately assigned. It is useful to discuss briefly the tax effects relative to various categories of assets.

**Franchises, Trademarks and Trade Names.**—The result of the operation of Section 1253 and the related proposed regulations can be very beneficial to the contingent payor who acquires a business with significant franchises, trademarks or trade names. Section 1253 allows a deduction under Section 162(a) to the purchaser for contingent amounts paid for franchises, trademarks and trade names and the seller is deemed to have received ordinary income. An exception to this rule is provided for sports franchises.

In an acquisition where Section 1253 property is acquired as part of the entire trade or business, proposed regulations discuss how contingent payments are allocated among all assets acquired. The regulations specify that an allocation is made on the basis of facts and circumstances of the particular case, including any written agreement between the seller and purchaser. If there is no written agreement and the facts and circumstances do not otherwise indicate, an allocation may be made among the intangibles acquired with the business, including goodwill, franchises, trademarks or trade names. The regulations go on to provide that an allocation of the contingent payment to Section 1253 assets would be appropriate, lacking any other contrary facts or circumstances.

It should be noted that, although technically the rules of Section 483 would cover contingent payments on Section 1253 assets, the operation of Section 483 generally has no effect on the purchase price, as the entire payment is treated as an ordinary deduction.

**Other Intangible and Tangible Assets.**—Contingent payments by their nature are generally not susceptible to valuation at the time of an acquisition and, as such, are not included in the basis of property acquired. At the time the contingency becomes fixed, the purchaser receives additional basis in the assets acquired.

Recovery of the additional amount paid for income tax purposes depends upon the nature of the underlying asset to which the payment is related and whether the asset is depreciable or amortizable. The method followed in *Associated Patentees, Inc. v. Commissioner* generally prescribes the manner in which certain assets not eligible for ACRS should be amortized. The court in *Associated Patentees* allowed as amortization the amount of contingent royalty paid for the year. Although the case was decided on an acquisition of patents, the same method has been extended to other assets, both tangible and intangible. It seems that this method may be applied where the contingent payments are made over the period which approximates the useful life of the related asset. Where the contingent payments are paid over a shorter period than the asset’s useful life, the additional basis should be recovered over the assets remaining useful life on a straight-line basis.

In the event contingent payments are made with respect to property qualifying under ACRS, proposed regulations under Section 168 discuss the method of recovery. The regulations provide that the resulting increase in basis results in a redetermined adjusted basis and a redetermined applicable percentage. The effect of these rules is to fractionally increase the otherwise fixed percentages provided under the ACRS system. Contingent payments made in years after the end of the recovery period would be expensed as paid.

**Contingent Payments and Section 338.**—Although regulations under Section 338 have not been published that discuss allocation of purchase price or the effect of subsequent contingent payments, it would appear contingent payments on stock purchases could be applied to the underlying assets acquired. To avoid reallocation of the contingent payment over the all assets acquired, it is recommended that the contingency be identified with specific assets. Further, for the reasons pointed out above, the use of the residual method for determining going concern value or goodwill is not recommended where contingent payments may be made.

**Summary**

In summary, it may be concluded that creative, aggressive acquirers are carving out new frontiers in taxable purchases by first resolving the effects of the tax benefit rule, Section 338 and the issues of going concern and goodwill and then reaching for new opportunities to assign values to items which can provide significant future income tax benefits.

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**Footnotes:**

107 Section 1253(e).