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Issues Involved in Allocation of Purchase Price in Stock and Asset Acquisitions, Including Impact of Section 1060

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ISSUES INVOLVED IN
ALLOCATION OF PURCHASE PRICE
IN STOCK AND ASSET ACQUISITIONS,
INCLUDING IMPACT OF SECTION 1060

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Table Of Contents

I. INTRODUCTION

II. SECTION 1060 -- SPECIAL ALLOCATION RULES FOR CERTAIN ASSET ACQUISITIONS
   A. Scope
   B. Purpose and Methodology
   C. Structure and Operation of Regulations
      1. Applicable Asset Acquisition
      2. Like-Kind Exchanges
      3. Residual Method Required
      4. Subsequent Adjustments to Consideration
         a. Effect of Disposition or Depreciation of Assets by Purchaser
         b. Specific Allocations of Subsequent Adjustments In Consideration to Certain Contingent Income Assets
      5. Reporting Requirements

III. AMORTIZATION OF CUSTOMER BASED INTANGIBLES
   A. Distinguishing Customer Based Intangibles From Goodwill
      1. The Early Service Approach -- The Mass Asset Doctrine
      2. Separability From Goodwill -- Demise Of The Mass Asset Theory
      3. Distinguishing Goodwill -- The Cases
      4. Amortization Of A Bank's Customer Deposit Base
   B. Establishing A Cost Basis
   C. Limited Useful Life
   D. Permissible Methods of Amortization
IV. DEDUCTIBILITY OF SECTION 1253 PAYMENTS

A. **Scope**

B. **Operation of Statute**

C. **Benefits of Section 1253 in Acquisition Under Section 1060**

V. TREATMENT OF COVENANTS NOT TO COMPETE AND SIMILAR PAYMENTS

A. **Scope**

B. **Contracts With Specific Allocations To Covenants Not To Compete**
   1. **In General**
   2. **The Tests**
      a. **The Economic Reality Test**
      b. **The Intent Test**
      c. **The Severability Test**
   3. **Burden Of Proof In Taxpayer Challenges**
      a. **Danielson**
      b. **Strong Proof**

VI. TREATMENT OF CONTINGENT PURCHASE PRICE FOR STOCK UNDER SECTIONS 1274, 1275 AND 453

A. **Scope**

B. **Applicability and Operation of Section 1274**

C. **Contingent Payments**
   1. **Applicability of Section 1274**
   2. **Computation of Issue Price of Instrument**
      a. **Treatment of Noncontingent Payments**
      b. **Treatment of Contingent Payments**
         (i). **Contingent Payments With No Guaranteed Minimum Amount**
         (ii). **Contingent Payments Due More Than Six Months After Becoming Fixed**
         (iii). **Contingent Payments With a Guaranteed Minimum and Without Adequate Stated Interest**
   D. **Applicability of Section 453 To Contingent Payments**
I. INTRODUCTION

This paper focuses on various issues involved in allocating the purchase price in stock and asset acquisitions. These issues are of particular importance in view of three major changes that were enacted by the Tax Reform Act of 1986 (TRA 1986). First, the TRA 1986 eliminated the preference for long-term capital gains,* and, as a result, the target corporation's selling shareholders are generally indifferent between having purchase price allocated to their stock or to covenants not to compete. Second, the TRA 1986 repealed the General Utilities doctrine, and as a result, most taxable sales of stand alone corporations that are not subchapter S corporations or C corporations with substantial net operating losses are effectuated as stock sales. A sale of stock without a Section 338 election avoids the double tax that would otherwise be payable on the sale of a corporation's assets followed by a liquidation. Third, the TRA 1986 added Section 1060, which provides special allocation rules for certain asset acquisition.

As a result of the repeal of the General Utilities doctrine, a much larger percentage of taxable acquisitions are structured as stock acquisitions, and as a result of the repeal of the preference for long term capital gains, there appears to be substantially more and larger allocations of purchase price in stock acquisitions to covenants not to compete and similar items, such as consulting arrangements.

This paper focuses first on the rules regarding allocations in asset acquisitions, and then on the rules regarding allocation issues that principally arise in stock acquisitions. First, Section II considers the rules of Section 1060 regarding the allocation of purchase price in asset acquisitions. Section III focuses on the amortization of customer based intangibles with particular emphasis on Citizens & Southern Corporation v. Commissioner, which deals with the amortization of a bank's core deposits. Section IV reviews the rules under Section 1253 regarding the treatment of amounts paid for transfers of franchises, trademarks and trade names.

Second, with regard to allocations in stock acquisitions, Section V focuses on allocations to covenants not to compete, and Section VI deals with the impact of Sections 1274, 1275 and 453 on contingent purchase price paid in stock acquisitions. These contingent purchase price rules bifurcate a contingent payment between a principal payment in respect of stock and an interest payment; therefore these rules are inherently allocation provisions.

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* Congress currently is considering restoration of the preference for long-term capital gains or alternatively, a tax rate reduction with respect to long-term capital gains.
II. SECTION 1060 -- SPECIAL ALLOCATION RULES FOR CERTAIN ASSET ACQUISITIONS

A. Scope

Section 1060 was enacted under the Tax Reform Act of 1986, and provides a method for allocating the purchase price for an ongoing business to the individual assets of the business. Because the sale of an ongoing business is treated, for tax purposes, as the sale of each individual asset of the business,* the purchase price must be allocated among the various assets of the business in order to determine the purchaser's basis in the acquired assets and the seller's gain or loss on the sale of those assets.

Section 1060 applies to "applicable asset acquisitions" occurring after May 6, 1986, unless such acquisitions are made pursuant to a binding contract that was in effect on May 6, 1986, and at all times thereafter. Section 1060(a) mandates the use of the "residual method" described in Section 338(b)(5) and Temporary Regulations §1.338(b)-2T and -3T for allocating the purchase price in applicable asset acquisitions. Section 1060(b) contains certain reporting requirements for "applicable asset acquisitions" that are to be made in the manner prescribed by regulations furnished by the Secretary. Section 1060(c) defines the "applicable asset acquisitions" to which the provision applies generally as the transfer of a group of assets which constitute a trade or business, in which transfer the purchaser's basis in the assets is determined wholly by reference to the consideration paid. Finally, Section 1060(d) provides rules for determining the value of goodwill or going concern value in the case of the distribution of partnership property or the transfer of a partnership interest to which Section 755 applies.

On July 18, 1988, the Internal Revenue Service promulgated Temporary Regulations §1.1060-1T which, inter alia, provide guidance regarding the application of Section 1060, modify the regulations relating to stock purchases treated as asset purchases under Section 338, and coordinate the application of Section 755 (relating to the transfer of a partnership interest) with the rules of Section 1060. The Temporary Regulations are effective as of July 18, 1988, and apply to "applicable asset acquisitions" occurring after May 6, 1986. Additionally, the Temporary Regulations explain

*Williams v. McGowan, 152 F.2d 570 (2d Cir., 1945).
the Section 1060 reporting requirements and clarify that they apply to asset acquisitions occurring in taxable years for which the due date (including extensions of time) of the taxpayer's income tax return is on or after September 13, 1988.

B. **Purpose and Methodology**

Prior to the enactment of Section 1060, the purchase price for an ongoing business was generally allocated among the assets of the business by the buyer and the seller in various ways. The parties could contractually agree to an allocation which the Internal Revenue Service and the courts generally accepted if the parties had adverse tax interests. A second method employed by taxpayers was to proportion the purchase price among the individual assets (including intangible assets such as goodwill) based upon each asset's respective value. Where the business was purchased for a premium (i.e., a price in excess of the aggregate fair market value of the assets), this method at times resulted in a "second-tier" proportional allocation of the premium among the assets. This method proved troublesome because of the inherent difficulty in valuing intangible assets in the nature of goodwill or going concern value. *

A third method of allocating purchase price to the assets of a business, and the method adopted by the Internal Revenue Service in the Temporary Regulations under Section 338(b), is the residual method. Under that method the deemed purchase price (in a qualified stock purchase treated as an asset purchase for tax purposes) is first reduced by cash and cash equivalent assets, and then is allocated sequentially to two defined classes of identifiable tangible and intangible assets, but only to the extent of the fair market values of those assets. Any remaining purchase price is allocated to goodwill and going concern value of the business. The residual method prohibits "second-tier" allocations.

Congress was concerned about the disparate tax treatment and the potential "whipsaw" of the Government that could result from the use of these various allocation methods. Additionally, Congress recognized the difficulty in valuing goodwill or going concern value when an ongoing

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*See, Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 355 et seq.; hereafter "General Explanation".
business was sold. Consequently, Congress required the use of one particular allocation method for the purchase price of an ongoing business.*

C. Structure and Operation of Regulations

1. Applicable Asset Acquisition

Section 1060 applies to all "applicable asset acquisitions." Temporary Regulation §1.1060-1T(b) defines "applicable asset acquisitions" as any transfer, whether direct or indirect, of a group of assets that constitute a trade or business in the hands of the seller or the purchaser, in which transfer the purchaser's basis in the assets is determined wholly by reference to the purchaser's consideration. (This cost basis rule does not apply in the case of certain like-kind exchanges.) Generally, a group of assets constitutes a trade or business if the use of such assets would qualify as an active trade or business under Section 355 of the Code. Even if a group of assets does not qualify as an active trade or business for purposes of Section 355, it will constitute a trade or business under Section 1060 if its character is such that goodwill or going concern value could, under any circumstances, attach to such group. In making this determination, all facts and circumstances surrounding the transaction are to be taken into account including (1) the excess of total consideration over the aggregate book value of the assets purchased (excluding goodwill and going concern value), as reflected in the buyer's financial statements; and (2) related transactions, including lease agreements, licenses, covenants not to compete and employment and management contracts between the buyer and seller.

Thus, for example, where a group of assets that constitute a trade or business in the hands of the seller are transferred to a purchaser that does not intend to continue the use of those assets in its trade or business, the transfer nonetheless constitutes an applicable asset acquisition because of the seller's use of those assets.**

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** See Temp. Reg. §1.1060-1T(b)(3), Examples 1 and 2.
2. **Like-Kind Exchanges**

The exchange of a group of assets constituting a trade or business for like-kind assets may constitute an applicable asset acquisition under Section 1060.* Assuming that the transaction is structured as a like-kind exchange under Section 1031 (or as an exchange governed by Sections 1035 or 1036) and that the other requirements of Section 1060 are met (i.e., the group of assets is of a character that goodwill or going concern value could attach to it), the transaction may be an applicable asset acquisition even though the purchaser’s basis in the assets is not determined wholly by reference to the consideration paid.** Section 1060 is applicable, therefore, to a like-kind exchange where the total value of the consideration transferred (i.e., the fair market value of property and the cash and/or liabilities assumed) exceeds the fair market value of property received in the exchange. Thus, the Temporary Regulations contain an example,*** where A transfers like-kind property to B with a fair market value of $1,000, and B transfers to A like-kind property with a fair market value of $100 plus cash of $1,000. All like-kind property that is considered to be transferred in exchange for like-kind property is excluded from the operation of Section 1060. Additionally, since $900 of the cash transferred by B was transferred in exchange for like-kind property in order to equalize the fair market values of the assets transferred, only $100 is subject to the allocation rules of Section 1060. The $100 must be allocated by B in accordance with the residual method under Section 1060(a) and Temp. Reg. §1.1060-1T(d) to goodwill and going concern value.

3. **Residual Method Required**

Section 1060 requires allocation of the purchase price in "applicable asset acquisitions" under the residual method. Transferred assets are categorized into four classes, e.g. Class I, Class II, Class III or Class IV.**** The purchase price is first reduced by the amount of any Class I assets

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*See Temp. Reg. § 1.1060-1T(b)(4).

**See Section 1031(d) for the determination of the basis of property acquired in a like-kind exchange to which Section 1031 (and Sections 1035 and 1036) applies.

***See Temp. Reg. § 1.1060-1T(g), Example 3.

****See Temp. Reg. § 1.1060-1T(d).
which consist of cash, demand notes or similar accounts in banks, savings and loans or other similar items designated in the Internal Revenue Bulletin. Thereafter, the remaining purchase price is allocated sequentially to Class II assets and then to Class III assets. Within a given class of assets, purchase price allocated to each asset may not exceed the fair market value of that asset. Class II assets are certificates of deposit, U.S. government securities, readily marketable stock or securities, foreign currencies and other items designated in the Internal Revenue Bulletin. Class III assets consist of all assets not included in Classes I, II or IV, both tangible and intangible, such as furniture, fixtures, land, buildings, leases, contracts, equipment, accounts receivable and covenants not to compete.

After allocation of the purchase price, reduced by Class I assets, to Class II and Class III assets, any residual purchase price is allocated to Class IV assets which consist of goodwill and going concern value.

Example 1 -- In an applicable asset acquisition under Section 1060, A transfers to B a group of assets with a fair market value of $56,000 plus goodwill. B pays $50,000 in cash and assumes $15,000 in liabilities. The group of assets consist of the following:

| Securities | $25,000 |
| Equipment  | 12,000  |
| Lease      | 4,000   |
| Inventory  | 15,000  |
| **Total**  | **$56,000** |

Under Temp. Reg. §1.1060-1T(d)(1), the consideration paid must be allocated sequentially to Class I, II, III and IV assets. Since there were no Class I assets sold, $25,000 of the $56,000 consideration is first allocated to the Class II asset, the Securities. The remaining consideration $40,000 ($65,000 - 25,000 = 40,000) is then allocated to the Class III assets. The remaining amount of consideration ($40,000) exceeds the aggregate fair market values of the Class III assets ($31,000) and accordingly, the amount of consideration allocated to each of the Class III assets is its fair market value. After the allocation to the Class III assets, the balance of the consideration ($9,000) is allocated to Class IV assets (i.e., to goodwill).

Example 2 -- Assume the same facts in Example 1 except that the total consideration paid is $50,000. In that case, after the allocation of $25,000 to the securities, the remaining consideration, $25,000, is less than the aggregate fair market values of the Class III assets, $31,000. Under Temp. Reg. §1.1060-1T(2), the remaining* See Temp. Reg. §1.1060-1T(d).
consideration is allocated to the Class III assets in proportion to their relative fair market values. In this case, each Class III asset would be allocated consideration of approximately 81% (i.e., $25,000 divided by $31,000 = 81%). Accordingly, $9,678 would be allocated to the equipment; $3,225 would be allocated to the lease; and $12,097 would be allocated to the inventory. Nothing is allocated to the goodwill.

4. Subsequent Adjustments to Consideration

Temporary Regulation §1.1060-1T(f) provides rules for redetermining or adjusting the allocations under Section 1060 when the consideration of the transaction is subsequently increased or decreased. Generally, an increase in consideration is allocated among the transferred assets in the same manner as the initial allocation under Temp. Reg. §1.1060-1T(d). The special limitations of Temp. Reg. §1.1060-1T(e) are still applicable so that consideration cannot be allocated to Class II or III assets in excess of their fair market values. Accordingly, in Example 1, supra, a subsequent increase in consideration would result in an additional allocation to goodwill because the initial allocation to the Class II and III assets was equal to their aggregate fair market values. In Example 2, supra, however, any subsequent increase in consideration would result in an additional proportional allocation to the Class III assets to the extent of their fair market values.

Subsequent decreases in consideration are allocated inversely to Class IV assets, then to Class III and Class II assets in proportion to their fair market values. Thus, in Example 1, supra, a decrease in consideration would first reduce the $9,000 allocated to goodwill and then the amounts allocated to the Class III assets and finally, the allocation to Class II assets.∗

a. Effect of Disposition or Depreciation of Assets by Purchaser

If an asset has been disposed of, depreciated, amortized, or depleted by the purchaser before an increase or decrease in consideration is taken into account, the increase or decrease in consideration that would have been allocable to that asset is taken into account under principles of tax law applicable when part of the cost of an asset (not previously reflected in its basis) is paid or reduced after it has been disposed of, depreciated, amortized or depleted.** One effect of a subsequent increase in consideration allocable to a depreciable asset for which depreciation


allowances had been claimed, would be a redetermination of the adjusted basis of the property as well as the applicable percentage for remaining depreciation allowances. Conversely, a subsequent reduction in consideration applicable to a depreciable asset for which depreciation allowances had been claimed could have the effect of reducing the adjusted basis of the asset below zero, in which case the purchaser may have gain.

Example 3 -- Assume that in 1989 A transfers to B, in an applicable asset acquisition, the following group of assets (plus goodwill):

<table>
<thead>
<tr>
<th>Asset</th>
<th>Original Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBM Stock</td>
<td>$10,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>4,000</td>
</tr>
<tr>
<td>Furniture &amp; Fix.</td>
<td>15,000</td>
</tr>
<tr>
<td>Lease</td>
<td>12,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>9,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$50,000</strong></td>
</tr>
</tbody>
</table>

B pays consideration of $55,000 in cash to A in 1989. Under Temp. Reg. §1.1060-1T(d), the consideration is allocated to all of the Class II and III assets to the extent of their fair market values, with the excess consideration of $5,000 allocated to goodwill. The equipment is 5 year property which is fully depreciated in 1994 and has an adjusted basis to B of zero. In that year, A refunds $6,000 to B due to a recovery on a suit. This decrease in consideration is first allocated, under Temp. Reg. §1.1060-1T(f)(3) to goodwill, the Class IV asset. After reducing the consideration allocated to goodwill to zero, $1,000 remains to reduce the amount allocated to the Class III assets in proportion to their relative fair market values on the purchase date. Since $1,000 equals 2.5 percent of $40,000 (the amount originally allocated to the Class III assets), the consideration for each Class III asset will be reduced by 2.5 percent of its fair market value as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Reduction</th>
<th>New Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$100</td>
<td>$3,900</td>
</tr>
<tr>
<td>Furn. &amp; Fix.</td>
<td>375</td>
<td>14,625</td>
</tr>
<tr>
<td>Lease</td>
<td>300</td>
<td>11,700</td>
</tr>
<tr>
<td>Accts. Rec.</td>
<td>225</td>
<td>8,775</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,000</td>
<td><strong>$39,000</strong></td>
</tr>
</tbody>
</table>

Because the basis of the equipment to B was zero immediately before the decrease in consideration, B is required to treat the equipment as if it were disposed of before the decrease is taken into account. Accordingly, in 1994, B recognizes income of $100, the character of which is determined under the principles of Arrowsmith v. Commissioner, 344 U.S. 6, (1952), and the tax benefit rule.


**See Temp. Reg. §1.1060-1T(g), Example 2.
b. **Specific Allocations of Subsequent Adjustments In Consideration to Certain Contingent Income Assets**

The Temporary Regulations contain rules relating the subsequent increases or decreases in consideration in an applicable asset acquisition where the subsequent changes are the result of a contingency directly related to intangible assets such as patents, secret processes, or copyrights. If there is a subsequent increase or decrease in consideration which involves both an amount related to a contingent asset and an amount unrelated to any contingent asset, the portion that is unrelated is allocated to all of the transferred assets (including any contingent assets) in the manner described above. Amounts received because of a payment related to a contingent income asset, are allocated directly to that asset. For purposes of this rule, the fair market value limitation is not applicable to the contingent asset, because its fair market value is redetermined when the increase or decrease in consideration is received.**

5. **Reporting Requirements**

Section 1060(b) requires parties to an applicable asset acquisition to furnish information to the Internal Revenue Service regarding the consideration transferred in the transaction, and Temp. Reg. §1.1060-1T(h) clarifies that such information is to include the amount of the consideration transferred in the transaction and its allocation among the assets transferred, as well as information concerning subsequent adjustments (increases or decreases) to the consideration. Under the Temporary Regulations, the seller and purchaser must each file asset acquisition statements on Form 8594*** with their income tax returns for the taxable year that includes the purchase date or the year in which subsequent adjustments to consideration occur.

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*See* Temp. Reg. §1.1060-1T(f)(4)(ii).

**Id.**

***Attached as Appendix A.
III. AMORTIZATION OF CUSTOMER BASED INTANGIBLES

Section 167(a) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or property held for the production of income. The rules relating to intangibles are set forth in Regulations Section 1.167(a)-3 which states, in relevant part:

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

The regulation can be summarized as embodying basically three requirements which must be satisfied in order for a taxpayer to be permitted a depreciation allowance with respect to an intangible: (i) the intangible must be separate and distinct from goodwill or going concern value; (ii) the intangible must have an ascertainable cost basis; and (iii) the intangible must have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

A. Distinguishing Customer Based Intangibles From Goodwill

Although the Treasury Regulations expressly prohibit amortization of goodwill, neither the Code nor the Treasury Regulations contain any definition of the concept. The regulations under Section 338 appear to indicate that goodwill is what is left of the purchase price after all other assets of the purchased enterprise have been valued. However, that description is not very helpful when the issue is whether a particular intangible can be distinguished from goodwill.

In common parlance, goodwill seems to refer to whatever it is about the relationship between a business enterprise and its customers that contributes to an expectation of continuing

*In the case of tangible property the method for calculating depreciation is found in Section 168. Section 167 continues to govern amortization of intangibles.

**Courts typically combine the first and second requirements and view the regulation as requiring (i) an ascertainable cost basis separate and distinct from goodwill and going concern value, and (ii) a limited useful life, the duration of which is ascertainable with reasonable accuracy. The substance is the same. For pedagogical purposes, we prefer the formulation in the text.
customer patronage. By and large, this appears to be the definition adopted by the courts. As early as 1893, Justice Story stated:

[Goodwill is] the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.

More recently, courts have described goodwill as the expectation that old customers will resort to the old place; or the expectancy of continued patronage, for whatever reason.

1. The Early Service Approach -- The Mass Asset Doctrine

Prior to 1974, the Service took the position that customer based intangibles such as customer lists, subscription lists and insurance expiration lists were nonamortizable as a matter of law. The doctrine which the Service employed has come to be known as the mass asset doctrine. Although the doctrine has been formulated in many different ways by many different courts, the basic idea was that customer based intangibles were to be viewed as mass assets which, because of their indefinite useful life and self-regenerating character, were part of the goodwill of the business enterprise.

The rule was first articulated in Danville Press, Inc. v. Commissioner. In that case, the taxpayer purchased all of the assets of a daily newspaper and allocated a portion of the purchase price to unexpired subscriptions. All of the subscriptions were to run out within 12 months of the purchase. The taxpayer sought to deduct 10/12ths of the amount allocated to the subscriptions on the theory that there were 10 months remaining in the tax year and it was therefore reasonable to assume that approximately 10/12ths of the subscriptions would expire during the taxable year. The court rejected the taxpayer's claim, holding that the subscription list was an asset whose value fluctuated from time to time.

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Several early cases relied on the concept to prevent taxpayers from amortizing the cost of a customer-based intangible. In each case, however, the court viewed the intangible as being closely related to goodwill.

In *Boe v. Commissioners*, for example, a taxpayer/doctor was a partner in a partnership which purchased the medical practice of a retiring physician. The major asset of the practice consisted of terminable at will contracts which the seller had signed with his patients. The partnership sought to deduct amounts allocated to individual contracts as patients were lost.

The court denied the deduction, reasoning that the contracts represented the goodwill of the business enterprise.

There were no 'other properties' of any substantial value except the contracts and they are, in our view, inseparable from the goodwill. They are terminable at will, and their value depends entirely upon the expectation that they will not be terminated—that is, the expectancy of continued patronage. We doubt if any value could properly be assigned to them, apart from good will. It is conceded that good will is not a depreciable asset.

The court then went on to hold that, even had the contracts been separable from goodwill, they constituted a mass asset and were not subject to individual loss deduction.

Moreover, and assuming that a part of the price can be assigned to the contract separate from the price of good will, they were still purchased as a single indivisible asset, as the Tax Court correctly found, and therefore they cannot be amortized under Section 23(l), or individually subject to loss deductions under Section 23(e), Internal Revenue Code of 1939.

2. **Separability From Goodwill - Demise Of The Mass Asset Theory**

The courts' dissatisfaction with the mass asset theory first appeared in *Seaboard Finance Company*, in which the Ninth Circuit affirmed the Tax Court and permitted

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*35 T.C. 720 (1961); aff'd, 307 F.2d 339 (9th Cir. 1962).

**307 F.2d 339 at 343.


****T.C. Memo 1964-253, aff'd 367 F.2d 646 (9th Cir. 1966).
amortization of favorable loan contracts. Seaboard purchased several consumer loan businesses, valuing each loan contract based on factors bearing on the borrower's credit worthiness. The purchase price exceeded the face value of the loans, and the premium was treated as a depreciable cost incurred in acquiring the contracts.

The Service raised two arguments: (i) that the premium was attributable primarily to the prospects for loan renewal, an element of goodwill; and (ii) that even if the premium were attributable to the loan contracts, the loan contracts constituted part of the customer structure of a going business which, in the view of the Service, was a mass asset which was not subject to amortization.

The Tax Court found that only 30 percent of the premium was attributable to goodwill. The court refused to apply the mass asset rule to the loan contracts because the contracts had an identifiable value apart from goodwill, and the purchase price had been determined by appraising the value of each contract.

Two years later, in Manhattan Company of Virginia v. Commissioner, the Tax Court allowed a taxpayer to amortize a portion of the price paid to acquire a customer list. In essence, the court found that the list served several purposes -- some of which were amortizable and others of which were not.

The taxpayer was in the home pickup-and-delivery laundry business and purchased the customer list from another laundry company that was eliminating its pickup operations but was continuing in the laundry business. The primary benefit of the list, the court found, was that it provided the taxpayer with names of people who used home pickup-and-delivery laundry service. That knowledge declined in value as people on the list ceased doing business with the taxpayer and the court permitted amortization over 5 years, based on its finding of anticipated annual customer attrition of 20 percent.

The court also found that 25 percent of the value of the list was attributable to benefits that had no ascertainable useful life. Several of the customers on the list were students at a nearby school, and the court found it likely that the school would be a continuing source of

*50 T.C. 78 (1968); acq. 1974-2 C.B.3.
business. In addition, a portion of the purchase price was attributed to the possibility that customers obtained from the list would be a source of referrals. Thus, the court permitted amortization of 75 percent of the cost of the list.

Finally, in *Houston Chronicle Publishing Company v. United States*, the 5th Circuit permitted a taxpayer to amortize the portion of the purchase price allocated to the subscription list of a purchased but discontinued newspaper. The court ruled that the mass asset rule does not prevent an amortization deduction if the taxpayer can establish that the asset (i) has an ascertainable value separate and distinct from goodwill, and (ii) has a limited life, the duration of which can be ascertained with reasonable accuracy. Because the purchaser discontinued the newspaper, there was no transfer of goodwill.

Faced with defeat in the Tax Court and the 5th and 9th Circuits, the Service acquiesced in *Manhattan Company* and issued Revenue Ruling 74-456, which essentially abandoned the view that customer based intangibles were nonamortizable as a matter of law and adopted the approach of the 5th circuit.

3. **Distinguishing Goodwill -- The Cases**

After Rev. Rul. 74-456, it is clear that an intangible asset may be amortized only if the taxpayer demonstrates that the asset (i) has an ascertainable value separate and distinct from goodwill, and (ii) has a limited life, the duration of which can be ascertained with reasonable accuracy. The problem is in gleaning the criteria for distinguishing an intangible from goodwill. Cases where a court finds, as a matter of fact, that the purchaser did not succeed to the goodwill of the seller seem clear. In *Houston Chronicle*, the purchaser used the customer list to augment sales of its own newspaper, but did not continue to publish the newspaper previously put out by the seller. In *Manhattan Company*, the purchaser acquired names of people who had previously used laundry pickup-and-delivery services, and the opportunity to seek business from those people. The seller actually remained in the laundry business, though it ceased pickup-and-delivery operations, and Manhattan did not use the seller's name. In *Seaboard Finance*, the purchase price was calculated by

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*481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974).*
valuing particular loan contracts, no attention was paid to the possibility of originating new loans
with current borrowers.

Other courts have permitted amortization under similar facts. In *Computing
Software, Inc. v. Commissioner,* the taxpayer acquired the assets of three credit-reporting
organizations and was allowed to amortize the portion of the purchase price allocated to files
containing credit information. The Tax Court found that the credit information represented the
product that the taxpayer had to sell, not the goodwill of the business enterprise.

In *Holden Fuel Oil Co. v. Commissioner,* the taxpayer purchased a customer list
from Gulf Oil Corporation when Gulf decided to get out of the retail market. Although Gulf did
send a form letter to its customers informing them that the taxpayer was now distributing Gulf oil
in the area, the court found that no goodwill had been transferred. Twenty five percent of the cost
of the list was attributable to continuing value (such as renewals and new business) and was not
amortizable. Accordingly, the taxpayer was allowed to amortize 75 percent of the cost of the list
(the taxpayer had established a 15 year useful life.)

In *Midlantic National Bank/Merchants v. Commissioner,* the Tax Court permitted
the taxpayer to amortize 90 percent of the cost of the right to solicit the customers of an acquired
bank. The court found that, in view of the fact that the acquired bank was insolvent and the
customers had suffered losses due to embezzlement by the bank’s former president, there was no
goodwill to be transferred. Ten percent of the cost was attributable to larger accounts which had
unascertainable useful lives and amortization with respect to that portion of the cost was not
permitted.

In *Panichi v. United States,* the U.S. Court of Appeals for the Second Circuit
permitted a taxpayer to amortize the cost of a customer list which was acquired from a refuse

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*64 T.C. 223 (1975); acq., 1976-2 C.B.1. See also, *Los Angeles Central Animal Hospital, Inc.
Commissioner,* 537 F.2d 446 (Ct. Cl. 1976).

**T.C. Memo 1972-45; aff’d per curiam, 479 F.2d 613 (6th Cir. 1973).

***T.C. Memo 1983-581.

****834 F.2d 300 (2nd Cir. 1987).
disposal business. The court found that no goodwill had been transferred because: (i) the taxpayer had sold only its trash collection operation while remaining in the refuse disposal business; (ii) only a fraction of the seller's customer route stops were sold to the taxpayer, the remainder was sold to other purchasers; and (iii) the taxpayer had not acquired the right to use the seller's trade name.

In circumstances where the taxpayer acquires both goodwill and other customer based intangibles, however, the result seems less certain. In *Bog*, for example, the court found that terminable at will patient contracts were indistinguishable from goodwill. Similarly, in *Golden State Towel and Linen Service, Ltd. v. United States,* the Claims Court found that customer lists acquired when a linen service corporation purchased two competitors were actually part of the goodwill of the purchased enterprise and applied the mass asset rule to prevent the taxpayer from taking deductions as accounts were lost. The court reasoned as follows:

In the instant case the cost of each lost customer was not provided by the contracts but was computed as that proportion of the sales prices allocated to customer lists which the average weekly billings to the lost customer bore to the aggregate billings for all customers on the lists. This is a somewhat more reliable method of evaluating each customer than in *Bog*, but is nevertheless subject to the valid criticism that the allocation of value to the aggregate customer lists was subjective and arbitrary, nor could it have been otherwise. It necessitated an implausible separation of customer lists from goodwill, one a mirror reflection of the other, for goodwill = expectancy of customer patronage = customer lists = goodwill. At least, if goodwill and customer lists are not mutually coextensive, the former includes the latter, and the lesser is inextricable from the greater. [cite omitted.]

In the vernacular, goodwill is a customer list with trimmings. The sellers agreed to cooperate in introducing their customers to the plaintiffs. Without such agreement the customer lists would have been of no more utility and value than the same raw information plucked from the yellow pages.

In *Skilken v. Commissioner,* the court prohibited a partnership from taking as a business loss deduction amounts which were allocated to oral terminable-at-will vending machine location agreements that were terminated during the taxable year. The court found that because the contracts were terminable at will, the taxpayer had in essence purchased goodwill.

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*373 F.2d 938 (Ct. Cl. 1967).*

**50 T.C. 902; aff'd 420 F.2d 266 (1970).
In General Television, Inc. v. United States, a taxpayer was prevented from amortizing subscriber lists acquired as part of the purchase of various cable television systems. The court found that the taxpayer had purchased customer structures that carried with them the expectancy of continued patronage, and held that the lists therefore constituted goodwill.

In other cases where customer based intangibles have been acquired in conjunction with goodwill, courts have allowed taxpayers to amortize the intangibles. For example, in Super Food Services, Inc. v. United States, the taxpayer acquired a food distributor and allocated a portion of the purchase price to several retail franchise contracts. All of the contracts were terminable by either party on thirty days notice. Thus, it was arguable that the contracts were an aspect of goodwill -- they depended upon the relationship between the franchisor and the seller. The court, however, was persuaded by the fact that the value and term of the contracts were readily determinable and permitted amortization deductions.

In Business Service Industries, Inc. v. Commissioner, the taxpayer sought to amortize various location contracts which entitled it to supply "Muzak" to various customers. The contracts had an average remaining term of approximately 14 months but the taxpayer’s expert found remaining useful lives of approximately 15 years (based upon historic renewal patterns). The contracts were then valued by determining the present value of the anticipated income stream over the 15 year period. Although the court quibbled some with the taxpayer’s determination of value, the basic approach -- valuing the contracts based on the anticipated revenue over the period that the taxpayer expected to retain each customer, was sustained. There was very little discussion of the possibility that this methodology arguably valued goodwill because it assumed the customers would renew their contracts after the remaining 14 month terms.


**416 F.2d 1236 (7th Cir. 1969).

***T.C. Memo 1986-86.
Finally, in *Donrey, Inc. v. United States,* the court permitted a taxpayer to amortize the cost allocated to a newspaper subscription list, even though the taxpayer continued to operate the newspaper under the same name. The court relied on *Houston Chronicle,* without noting that in that case there had been no transfer of goodwill because the purchaser discontinued the seller's newspaper.

4. **Amortization Of A Bank's Customer Deposit Base**

Since *Seaboard Finance,* the courts have recognized that the question of whether a particular customer based intangible is distinguishable from goodwill is a question of fact. Unfortunately, the courts do not appear to agree on what facts are important to the inquiry. Where the facts indicate that no goodwill has been transferred in the transaction, the answer is easy -- the customer based intangible is necessarily distinguishable from goodwill.

In circumstances where goodwill is transferred, however, courts do not appear to agree on the proper criteria for distinguishing the intangible from goodwill. In cases such as *Super Food Services, Business Service Industries* and *Donrey* courts look to whether the intangible has a reasonably ascertainable value and a reasonably ascertainable useful life. If it does, the courts find that the intangible is separate from goodwill. In cases such as *Boe, General Television* and *Golden State Towel,* courts look to whether the value of the intangible lies in something other than the expectancy of continued customer patronage. If it does not, the court finds that the intangible is merely an aspect of goodwill.

The dichotomy in approaches is perhaps best illustrated by the recent decisions in *AmSouth Bancorporation v. United States*** and *Citizens and Southern Corporation v. Commissioner.* Both cases involved the question of the ability of a bank to amortize the customer deposit base acquired in connection with the purchase of another bank.

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*809 F.2d 534 (8th Cir. 1987). See also, First Pennsylvania Banking & Trust Co. v. Commissioner, 56 T.C. 677 (1971), acq., 1972-1 C.B.2.*

**681 F. Supp. 698 (N.D. Ala. 1988), appealed (11th Cir. May 6, 1988).**

***91 T.C. No. 35.*
When a bank accepts a deposit, two accounting entries are made. There is a debit (asset) entry for cash received, and an offsetting credit (liability) entry representing the bank's obligation to return the money to the depositor. The bank's deposit base is, however, more valuable than the face amount of the deposits. The reason is that the bank will earn a higher rate of return by investing deposited funds than it will pay to its customers. An estimated useful life of the deposit base can be determined by observing historical patterns in the bank's customer account records, and the value of the deposit base can be calculated by discounting the estimated future earnings to present value. Future earnings are estimated at the excess of earnings from the deposit base (adjusted for float and reserve requirements) over the cost of depositor funds.

The issue was first brought before the courts in *Banc One Corp. v. Commissioner,* and *Southern Bancorporation v. United States.* In both cases, the taxpayers had first sought to allocate part of the premium paid to depreciable loan premium. When those arguments failed, the taxpayers argued the premium was allocable to an intangible known as "customer deposit base," which, the taxpayers also maintained, could be amortized.

The taxpayers lost in both cases because the courts objected to the methodology employed in establishing that the deposit base had a limited useful life. The taxpayers sought to establish useful life by looking to post acquisition operating results. The courts rejected the approach, holding that Section 167 requires that depreciation be calculated based on conditions known to exist at the end of the period for which the return is made.

In both *Amsouth* and *Citizens and Southern* the taxpayer avoided this problem by estimating useful life from records that existed at the time of the acquisition. Thus, the question of the amortizability of deposit base was squarely before both courts.

In *Amsouth,* Judge Propst found that the value of the deposit base depended on the expectation that the depositor would leave his cash in the bank -- i.e., the bank's goodwill. Thus, he concluded that the intangible was inseparable from that goodwill.

At the possible risk of being too simplistic, the court would make the following observation. When deposits are made, two

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accounting entries result. First, there is a debit (asset) entry for cash or its equivalent. Second, there is an equal and offsetting credit (liability) entry for the liability to the depositor. Any additional asset must be different from the cash thereby acquired. Its creation must, somehow, result from the expectation that the depositor will allow the cash, or its equivalent, to remain as an asset and that earnings will result therefrom. This expectation is akin to, if not tantamount, to the expectancy that ‘old customers will result to the old place’ of business or continued ‘customer patronage.’

For accounting purposes, a bank may be able to ‘identify’ a customer deposit base even though it may not be separate and distinct from goodwill. To the extent that deposits remain after some contractually stipulated period, they result from ‘continued patronage.’ The mere fact that deposits themselves are identifiable, does not make their "value" separate and distinct from goodwill.

In Citizens and Southern, on virtually identical facts, the Tax Court reached the opposite conclusion. In a reviewed decision, Judge Goffe found that the deposit base had a determinable value and an ascertainable useful life and permitted amortization.

The evidence in the instant case establishes that the acquisition of core deposits was the primary reason petitioner purchased the Acquired Banks and the petitioner paid a premium in order to obtain the core deposits.... The value is based solely upon the core deposits acquired in the purchase.... Furthermore, the value of deposit base does not depend upon a vague hope that customers will patronize the bank for some unspecified length of time in the future.... The value of deposit base rests upon the ascertainable probability that inertia will cause depositors to leave their funds on deposit for predictable periods of time. We conclude that deposit base has an ascertainable cost basis separate and distinct from the goodwill and going concern value of the Acquired Banks.

In a strong dissent, Judge Williams adopted Judge Propst's reasoning in AmSouth and concluded that customer deposit base was inseparable from goodwill.

So who's right? Does the fact that an asset can be identified, valued and given a useful life establish that the asset is distinguishable from goodwill? Or is it also necessary to show that the value of the asset derives from something other than the expectation of continued patronage?

The answer depends on how one views the prohibition on amortization of goodwill. If the reason for the prohibition is the view that goodwill has no readily ascertainable useful life, the

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*681 F. Supp. 698 at 720.

**91 T.C. ___ No. 35 at 3466.
fact that an asset can be identified and assigned a value and a useful life plausibly indicates that the asset is not part of goodwill. If, on the other hand, goodwill is more broadly viewed as the expectation of continued patronage, the view of Judge Propst should prevail.

If the approach taken in Citizens and Southern is ultimately sustained, does that mean a customer list will be amortizable whenever it has an ascertainable value and useful life? Probably, but not necessarily. It may be possible to distinguish deposit base from typical customer lists by maintaining that a deposit base is valued by reference to the amount of money on hand at a particular time while valuation of a customer list typically involves estimating future business. The problem is that there does not appear to be a principled reason for the distinction. If looking to future business to value customer lists necessarily involves goodwill, so should assuming that bank depositors will keep their deposits at the same bank. In addition, a narrow reading of Citizens and Southern would likely require reversals in Business Service Industries and Donrey.

B. Establishing A Cost Basis

This is generally the easiest of the requirements to satisfy. Where the intangible is acquired as part of a going concern, Section 1060 generally requires that the purchase price be allocated among assets other than goodwill to the extent of the fair market value of each, with the remainder being allocated to goodwill. The fair market value of a customer based intangible will typically be determined under a capitalized earnings approach -- the taxpayer estimates the income stream anticipated from the intangible and discounts that income stream to its present value. Taxpayers would be well advised to obtain appraisals prior to the closing and, in light of the reasoning in Seaboard Finance, each element of the intangible should be separately valued (if at all possible).

In circumstances where the intangible is acquired apart from a going concern, the basis of the intangible will normally be its cost.

C. Limited Useful Life

The Treasury Regulations under Section 167 allow amortization of intangibles only if the useful life of the intangible can be estimated with reasonable accuracy. Taxpayers have relied on statistical and actuarial evidence, company experience, industry data and appraisal reports. In
certain instances establishing a limited useful life may be difficult. In *Thriftcheck Service Corp.*, for example, the court ruled that customer contracts did not have readily ascertainable useful lives because of the existence of automatic renewal and cancellation clauses. In *Business Services*, however, the Tax Court found that renewable customer contracts with nominal 5-year terms had useful lives of 20 years. The court relied on evidence that approximately 5 percent of the contracts terminated each year. Similarly, in *Citizens and Southern*, the Tax Court relied on the bank’s historical experience regarding the duration of various types of customer accounts. Thus, the clear trend of recent cases is to find an ascertainable useful life if the taxpayer presents credible evidence. In this regard, an appraisal at the time of acquisition or soon thereafter is particularly helpful.

D. **Permissible Methods of Amortization**

Section 167(a) provides for the deduction of a reasonable allowance for depreciation. Section 167(b) prescribes a nonexclusive list for computing the reasonable allowance but Section 167(c) provides that the only method listed in Section 167(b) that applies to intangibles is the straightline method.

Based on this statutory framework, courts have permitted use of the straightline method as well as any other method that (i) is not listed in Section 167(b) and (ii) results in a more reasonable depreciation allowance than does the straightline method. Thus, in *Union Bankers Insurance Company v. Commissioner*, the taxpayer established that reinsurance assumptions which it purchased had a 7 year useful life and that at least 20% of the value would be used up in the first year. The court permitted a 20% depreciation allowance in the first year. The remaining 80% was amortized ratably over the remaining 6 years.

In *Citizens and Southern*, the Tax Court permitted the taxpayer to take a depreciation deduction in each year equal to the present value of the projected earnings from the acquired deposit accounts during such year. The court found that since the deposit base was valued by calculating the present value of the projected earnings, the present value of the earnings for each year was the most appropriate measure of the depreciation of the deposit base for the year.

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*See Computing & Software, Inc. v. Commissioner, 64 T.C. 223 at 237.*

**604 T.C. 807 (1975). See also, KIRO, Inc. v. Commissioner, 51 T.C. 155 (1968).*

-22-
IV.  DEDUCTIBILITY OF SECTION 1253 PAYMENTS

A.  Scope

An applicable asset acquisition may involve the transfer of intangible assets such as a franchise, trademark or trade name. These assets constitute Class III assets pursuant to Section 1060 of the Code. As with other assets transferred in a transaction subject to Section 1060, the consideration paid for these assets must be allocated in accordance with the residual method prescribed in Temp. Reg. §1.1060-1T(d). Frequently, however, payments made to the seller by the buyer with respect to the transfer of a franchise, trademark or trade name are payable over a period of time and are measured by a percentage of the selling price of the products sold or based on the units manufactured or sold, or some other similar method contingent upon production, sale or use.* Prior to the enactment of Section 1253 of the Code, these payments at times were treated as payments for a license and were given ordinary income treatment. Alternatively, the form or payment was disregarded with the result that all of such payments were treated as in exchange for a capital asset. However, these payments generally could not be deducted through depreciation or amortization because franchises, trademarks and trade names were considered to be intangible assets with unascertainable useful lives.

To alleviate the uncertainty of the tax treatment of the transfer of franchises, trademarks and trade names, Congress enacted Section 1253 in 1969. This provision distinguishes between transfers of franchises, trademarks and trade names that are treated as sales of capital assets and those treated as the transfer of a license in the asset. Additionally, the provision prescribes the appropriate tax treatment for installment payments involved in either type of transfer.

B.  Operation of Statute

Section 1253 separates transfers of franchises** into three categories. First, any payments upon the transfer, sale, or other disposition of a franchise that are contingent upon the

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**References hereafter to "franchises" include trademarks and trade names insofar as the tax treatment accorded these types of assets is essentially identical.
productivity, use, or disposition of the franchise constitute ordinary income to the transferor and are deductible under Section 162 (a) as trade or business expenses by the transferee.°

Second, where a franchise is transferred for a noncontingent payment and the seller does not retain any significant power, right, or continuing interest with respect to the subject matter of the franchise, the transfer is treated as the sale or exchange of a capital asset.** Any payments (in a lump sum or otherwise) made for the franchise that are not contingent on the productivity, use or disposition of the franchise are treated as amounts exchanged for a capital asset. Thus, if the franchise were transferred as described above in an applicable asset acquisition to which Section 1060 applied, an amount of consideration not greater than the fair market value of the franchise would be allocated to that asset. If the franchise had an ascertainable useful life, the purchaser would be able to recover its costs through amortization or depreciation.***

The third category consists of a transfer of a franchise where the transferor retains any significant power, right, or continuing interest in the subject matter of the franchise. Pursuant to Section 1253(a) the transfer is not treated as the sale or exchange of a capital asset but rather as a license. Section 1253(b)(2) contains the following list of "significant powers, rights or continuing interest" which will disqualify the transfer of a franchise as a sale or exchange:

(A) A right to disapprove any assignment of such interest, or part thereof.

(B) A right to terminate at will.

(C) A right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment facilities used to promote such products or services.

(D) A right to require that the transferee sell or advertise products or services of the transferor.

(E) A right to require that the transferee purchase substantially all supplies and equipment from the transferor.

°See, Sections 1253(c) and (d)(1).

**Section 1253(a).

***Even though the costs of a franchise may be recovered through amortization or depreciation, franchises generally do not have an ascertainable useful life. Consequently, the purchaser generally may not claim any amortization or depreciation deductions. See S. Rept. No 552, 91st Cong., 1st Sess. at 210; 1969-3 C.B. 423, 556.
(F) A right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred if such payments constitute a substantial element under the transfer agreement.

Pursuant to Section 1253(d)(2), noncontingent payments transferred in exchange for a franchise, where significant powers or a continuing interest is retained by the transferor, are includable as ordinary income by the transferor, and the transferee is allowed to deduct the payment or a series of payments over a period of years.

Section 1253(d)(2)(A) through (C) and proposed Regulations §1.1253-1 through -3 provide rules for the deductibility of noncontingent payments exchanged for a franchise. As a general rule, a single noncontingent payment is deductible ratably over a ten year period, unless the transfer agreement is greater than ten years, in which case, the payment is deductible over the period of the transfer agreement.** If the payment is a series of equal payments (whether or not in consecutive taxable years) that is payable over a period of time that is more or less than ten years, the payments are deductible in the taxable year in which they are made.*** The Proposed Regulations also contain rules with respect to the deductibility of a series of unequal payments made either over the period of the transfer agreement, or a period of more or less than ten years.****

C. Benefits of Section 1253 in Acquisition Under Section 1060

Where an applicable asset acquisition to which Section 1060 applies and which involves the transfer of an intangible asset such as a franchise, Section 1253 provides a mechanism, through ratable deductions over a period of years, for the purchaser to recover its cost of acquiring that intangible asset. Thus, it is generally in the interest of the purchaser to

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* A notice or proposed rulemaking under Section 1253 was published in the Federal Register on July 14, 1971. Although these Proposed Regulations have not been finalized, they provide guidance as to the treatment of various payment arrangements for franchises, trademarks and trade names under Section 1253.


***See, Prop. Reg. §1.1253-(c)(3)(ii) and (iii).

allocate as much as possible of the consideration paid for a continuing business to the franchise acquired in the transaction. Such an allocation must, however, be able to pass Internal Revenue Service scrutiny.

The payment or payments are only deductible under Section 1253 if the seller or franchisor retains significant powers, or a continuing interest in the subject matter underlying the franchise.

The Internal Revenue Service has ruled* that payment for a franchise transferred by a franchisee in an applicable asset acquisition were deductible by the transferor under Section 1253. In that ruling, Z transferred to Y a franchise with Z retaining significant powers, rights and continuing interest in the franchise. Under Section 1253 (which was not in effect at the time of Z’s transfer to Y), Y would have been entitled to deduct any noncontingent payments made to Z for the franchise. Some years later, after the enactment of Section 1253, Y sold its entire business to X for $200,000 in an applicable asset acquisition to which Section 1060 applies. Along with the other assets of its business, Y transferred its franchise rights to X (with the prior approval of Z) subject to the continuing significant powers and continuing interests of Z, the original franchisor. Y and X allocated $10,000 of the purchase price to the franchise rights, and the issue presented was whether X was entitled to claim amortization deductions for that amount under Section 1253(d)(2).

The Service concluded that since Y did not retain any significant powers or continuing interests in the franchise, the transfer of the franchise to X constituted the sale or exchange of a capital asset to Y. Under the general rule of Section 1253(a), since there were no contingent payments, X would normally be denied any recovery of its cost of acquiring the franchise, unless X could establish a useful life for the asset. However, in this situation, the franchise X acquired remained subject to the significant powers and continuing rights of Z. If X had acquired the franchise directly from Z subject to such powers and rights, X would be entitled to amortize its costs over ten years.

The Internal Revenue Service held that X was entitled to amortize its cost of acquiring the franchise in light of Congressional intent to provide such benefit to a taxpayer who acquired a

franchise subject to significant powers, rights or continuing interests. The tax treatment should not turn upon whether the franchise was obtained from the franchisor or from a prior franchisee. Additionally, although the consideration was paid to the prior franchisee (Y), the franchisor (Z) was a party to the transaction because its consent was required for the transfer of the franchise. Moreover, the franchise rights run from the franchisor to the new franchisee, and the franchisor retains significant powers, rights and continuing interests in the franchise. Thus, in this situation, both Y and Z are considered to be transferors of the franchise and X is entitled to amortization deductions because the transfer is subject to the restrictions that prevent the transfer from being treated as a sale or exchange under Section 1253(a).

This "look-through" approach has been applied by the Internal Revenue Service in a number of different fact situations. In one transaction, for example, B acquired all of the stock of a corporation A, and B made an election under Section 338 to treat the stock sale as a sale of assets. Under Section 338, A, the target corporation, was treated (1) as having sold all of its assets on the acquisition date in a transaction to which Section 337 applies, and (2) as new corporation A, which purchased all of such assets as of the beginning of the day after the acquisition date. One of the assets transferred was a franchise which was subject to the retained powers and interests of the original franchisor, whose only connection to this transaction was its consent to the transfer of the franchise. Under Section 338(b) a portion of the purchase price for the assets was allocated to the franchise. The Internal Revenue Service held that both Old A and the original franchisor were transferors of the franchise to New A, which, as transferee of a franchise subject to retained significant powers and continuing interests, was entitled to amortize the purchase price under Section 1253(d)(2).

*See, Private Letter Ruling 8736047, June 10, 1987

**This result has been ruled acceptable by the IRS in other similar situations such as a reverse subsidiary merger followed by a Section 338 election where a franchise was transferred in the deemed purchase of assets (See, Private Letter Ruling 8839035, June 30, 1988); a stock purchase between members of an affiliated group of corporations followed by a Section 338 election where the transfer of a franchise was held not to be an intercompany transaction under Reg. §1.1502-13(a)(1) (See, Private Letter Ruling 8828045, April 15, 1988); a stock purchase followed by a Section 338 election where the acquired corporation was liquidated after the deemed sale of assets (See, Private Letter Ruling 8728010, April 3, 1987).
V. TREATMENT OF COVENANTS NOT TO COMPETE AND SIMILAR PAYMENTS

A. Scope

As a general rule, payments received under a covenant not to compete are treated as ordinary income to the seller/recipient on the theory that these payments are analogous to compensation to the seller for refraining from engaging in business. Rev Rul 68-636 establishes that a covenant not to compete that is entered into in connection with a sale of stock is amortizable where the covenant is separate from goodwill and has an ascertainable useful life.

The buyer will want to allocate as much as possible to the covenant since the price therefor can be amortized over its stated life. As a result of the repeal of the preference for long term capital gains by the Tax Reform Act of 1986, sellers are generally indifferent between the allocation of purchase price between stock or assets sold and a covenant not to compete.

Although this section deals solely with covenants not to compete, similar principles apply in determining the proper treatment of consulting arrangements.** Also, consideration in any acquisition should be given to other possible deductible items such as software.***

There are numerous cases involving the proper treatment of amounts allegedly paid for a covenant not to compete. They can be divided into two broad categories: (1) those involving a contract with specific allocation to the covenant, and (2) those either (a) not mentioning the covenant explicitly or (b) mentioning the covenant but not including any specific allocation thereto.

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*1968-2 CB 92.

**See e.g., Yelencsios v. Commissioner, 74 T.C. 1513 (1980) (consulting agreement followed); and Mackey's Inc. v. Commissioner, 34 TCM 1214 (1975) (consulting agreement ignored).

***See Rev Rul 69-21, 1969-2 CB 303 (allowing amortization over 60 months for costs of software). But see Rev Rul 89-23 IRB 1989-10, 4 (packaging design was treated as nonamortizable intangible). See however Rev Proc 89-17 IRB 1989-10, 23 (allowing amortization of such costs in certain cases).
B. **Contracts With Specific Allocations To Covenants Not To Compete**

1. **In General**

Cases in this area have been described as being in "bewildering disarray," *Proulx v. United States,* yet a few general observations may be made. First, courts appear to be more sympathetic, and hence more willing to scrutinize the bona fides of a covenant, when an allocation is challenged by the Commissioner rather than the taxpayer." This tendency stems from the view that taxpayers should be bound by their agreements. The Supreme Court expressed this well in *Commissioner v. Nat. Alfalfa Dehydrating***:

This court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not (citations omitted).

And in *Balthrope v. Commissioner*** Judge Wisdom noted that "when a taxpayer has failed to arrange his affairs so as to minimize his taxes he cannot expect the court to do it for him nunc pro tunc."

Second, courts appear more likely to change an allocation contained in the contract when both the buyer and seller are before the court. Presumably judges feel more comfortable about refashioning an agreement when they have jurisdiction over both parties and can be assured that the decision will not result in any "whipsaw" of the government." In *Freeport Transport, Inc. v. Commissioner,* a majority of the Tax Court held that where both parties

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*594 F.2d 832 (Ct. Cl. 1979).*

**See Ullman v. Commissioner, 264 F.2d 305 (2d. Cir. 1959); Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979); Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), cert. den., 389 U.S. 858 (1967).*

***417 U.S. 134, 149, 94 S.Ct. 2129, 2137 (1974).*

****356 F.2d 28, 34 (5th Cir., 1961).*

*****See, e.g., Schmitz v. Commissioner, 51 T.C. 306 (1968), aff'd sub nom Thronson v. Commissioner, 457 F.2d 1022 (9th Cir. 1972); Schulz v. Commissioner, 34 T.C. 235 (1960), aff'd, 294 F.2d 52 (9th Cir. 1961).*

******63 T.C. 107 (1974).*
were before the court there was no basis for invoking the burden of proof standard set forth in Danielson, discussed infra.

2. The Tests

Courts usually rely on one of three tests in determining whether a specific allocation to a covenant will be recognized for tax purposes. The most widely used, known as the "economic reality" test, focuses on the economic circumstances of the transaction. A second test is based on the intent of the parties, while the third, the severability test, attempts to discern whether payments under the covenant are really payments for goodwill.

a. The Economic Reality Test

The rationale for the economic reality test, as propounded in Schulz v. Commissioner, involves inquiry into a variety of factors. Even where the parties have assigned value to a covenant in their contract,

the covenant 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.

In Schulz, the Service challenged amortization deductions claimed by the buyer for amounts paid pursuant to a covenant not to compete. The Tax Court denied those deductions, agreeing with the Commissioner that the purported covenant was in fact a sale of goodwill. The Tax Court based its conclusion on findings that the buyers knew that the seller did not wish to compete, had neither the technical background nor sales contracts necessary to compete, and that the seller would be unlikely to compete during the one-year term of the covenant because of the Korean War.*** The Ninth Circuit affirmed the Tax Court's holding, noting that they were also...

*Judge Dawson, in a concurrence joined by six judges, stated that when both parties were before the court the substance rather than the form of the transaction should control.

**294 F.2d 52, 55 (9th Cir. 1961); accord, Balthrop v. Commissioner, supra; see also Rev. Rul. 77-403, 1977-2 C.B. 302, discussed infra.

impressed by the evidence indicating that the covenant was not even considered until late in the negotiations."

The Service has adopted a similar test. In Revenue Ruling 77-403, supra, the Service stated that whether payment for a covenant not to compete given in connection with a sale of property is part of the cost of the property or a separate item "depends on whether the covenant has any demonstrable value." The factors seen as important are:

(1) whether in the absence of the covenant, the covenantor would desire to compete with the covenantee; (2) the ability of the covenantor to compete effectively with the covenantee in the activity in question; and (3) the feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant. See Schulz v. Commissioner, 294 F.2d 52 (9th Cir. 1961).

In that ruling, the Service found that although the parties had characterized part of the price as consideration for a covenant, the covenant had no demonstrable value. Thus, the ruling held that payments to the seller pursuant to the terms of the covenant were to be treated as part of the purchase price of the assets.

An equal division of payments under a covenant among selling shareholders may be evidence of a lack of economic reality. For example, in Dixie Finance Co., Inc. v. U.S.,* the stock purchase agreement allocated $526,000 of a $650,000 purchase price to covenants not to compete. The selling shareholders stated that the allocation was never discussed, and that they were asked to sign the covenants after the stock purchase agreement had been executed. They presented evidence showing that payments under the covenant were divided equally among all shareholders, even those that had refused to sign a covenant, and that the buyer failed to be sure the covenants were not violated. The district court, before which the buyer litigated its right to amortize sums allocable to the covenant, found no substantial economic basis for the covenant,

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*Schulz, supra, at 54-55. See also Lemery v. Commissioner, 52 T.C. 367 (1969), where the court described the seller's testimony regarding determination of the total purchase price and the allocation to the covenant as being so "inconclusive as to suggest that the $200,000 figure was in fact 'carved out' after the total purchase price has been agreed upon." Id. at 376. It should be noted, however, that the court described several other problems with the allocations in the contract of sale, making it impossible to state that the fact that the allocation was carved out after the parties had agreed on a price was the basis of the court's holding.

**474 F.2d 501 (5th Cir. 1973).
and stated that the evidence regarding equal division of the payments, the buyer's failure to police the agreement and the excessive allocation to the covenant was "more than sufficient" to support a finding that the amortization deductions should be disallowed.

Language discussing the economic reality of a covenant appears in many cases, yet few courts have actually disregarded a specific allocation using this test. Apparently the only non-consolidated case (i.e., a case in which only the purchaser or the seller, but not both parties, is before the court) in which that happened is Coven v. Commissioner. Coven involved a "Consultant Contract" executed by an accountant who had sold his interest in an accounting partnership to a former partner. The Tax Court found that Coven had presented strong proof that the form of the contract did not reflect its substance, and held that the payments did not constitute compensation for services. The court relied on several factors, including (1) no services were actually rendered under the contract; (2) payments were to continue after Coven's death; and (3) Coven did not expect to render any services, and was required by the contract to do so only at his convenience. Courts have upset specific allocations in a few consolidated cases, but each of those cases involves a unique fact pattern.


**Schulz, supra, was one of the consolidated cases in which an allocation was overturned.

In Throndson, supra, a case involving the dissolution of a dentistry partnership, the buyer and seller orally agreed to a purchase price. Thereafter, the buyer requested that part of the price be allocated to a covenant, and seller's attorney agreed without discussing the issue with the seller. The seller's attorney subsequently sent a letter to the buyer setting forth the understanding. The Tax Court held that the allocation was invalid because the letter of agreement containing it was executed without proper authority, hence the only enforceable contract was the oral one that involved no specific allocation.

In Nye v. Commissioner, 50 T.C. 203 (1968), two partners executed a covenant not to compete with the corporation to which the assets of the partnership were transferred. The Tax Court held that the purported covenant lacked economic substance since the partners were directors of the transferee corporation, and thus were prohibited from competing with it under state law.

See also, General Insurance Agency v. Commissioner, 401 F.2d 324 (4th Cir. 1968) (directors of seller covenanted not to compete with seller, then transferred covenant to buyer; *held*: allocation invalid -- buyer did not request covenant, covenant was unenforceable, no likelihood of competition); United Finance and Thrift Corporation of Tulsa v. Commissioner, 282 F.2d 919 (4th Cir. 1960) (taxpayer sellers testified that purpose of covenant was to protect value of transferred assets, Tax Court accordingly reallocated part of the consideration for the covenant to goodwill).
At least one court has decided that the economic reality test may only be used by the Commissioner, and others have expressed more general doubts about its validity. In Harvey Radio, supra, the court said "we do not agree that a taxpayer... can freely avoid the consequences of his agreement by showing that the 'economic realities' were otherwise, [but] we have no quarrel with those cases which accord such an option to the Commissioner." Also, the court in Clesceri v. United States** said that permitting broad challenges of the economic reality of a covenant by the parties thereto "encourages taxpayers to disregard their knowingly negotiated allocation in the hope that they can challenge it successfully and avoid taxes.***

As a practical matter, in view of the repeal of the preference for long term capital gains it can be expected that most cases arising after repeal will involve situations in which the Commissioner, on the basis of the economic reality test, challenges a purchaser's deductions for amounts that have been allocated by the parties to a covenant not to compete.

b. The Intent Test

A second test was enunciated by the First Circuit in Harvey Radio, supra. This case directs the court to look not at the economic reality of a covenant, but at the intent of the parties:

if the parties to a sale have affirmatively agreed to an allocation, they should not be able to state, later, to the Commissioner, that their agreement was meaningless.****

Under this approach, a party wishing to repudiate an allocation must prove that the parties intended some allocation other than that set forth in the agreement.*****

c. The Severability Test

The third test, which was used widely prior to the Ninth Circuit's Schulz opinion, is not in favor today. This test, known as the "severability" test, considers whether the covenant

*See Harvey Radio Laboratories, Inc. v. Commissioner, 470 F.2d 118, 120 (1st Cir. 1982).
**79-2 USTC ¶ 9738 (N.D. Ill. 1979).
*** See e.g., Beghe, Income Tax Treatment of Covenants Not to Compete, Consulting Agreements and Transfers of Goodwill, 30 Tax Lawyer 587 (1977).
****Harvey Radio, supra, at 120.
***** See also, Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962).
can be segregated and valued independently from the other assets that are transferred. If the covenant has been treated as a separate item, the consideration received thereunder is "severable" and should be included as ordinary income.*

3. Burden Of Proof In Taxpayer Challenges

Not only have different circuits adopted different tests for determining whether a specific allocation to a covenant can be disregarded, they have also adopted different burdens of proof where a taxpayer attempts to avoid using a specified allocation method. Thus the likelihood that a challenge to a covenant by a covenantor or covenantee will be successful will depend in large part on the court before which the case is tried.**

a. Danielson

The most stringent rule, known as the Danielson rule, is used by the Third Circuit and the Court of Claims.*** In Danielson, the Third Circuit adopted a rule proposed by the Commissioner that:

a party may 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.****

b. Strong Proof

The most widely used standard in a case in which the taxpayer is attempting to depart from an express allocation provision is known as the "strong proof" rule.***** The seller in Ullman had attempted to disregard an express allocation to the covenant. The Second Circuit denied this attempt, stating that "strong proof must be adduced by [the seller] in order to

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**Under the rule of Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971), the Tax Court will follow the rule enunciated by the circuit to which an appeal in the case would lie. See, e.g., Feller v. Commissioner, supra.

***Commissioner v. Danielson, supra; Proulx v. United States, supra.

****Danielson, supra, at 775.

*****See Ullman v. Commissioner, supra; Clesceri v. United States, supra.
overcome that declaration." This test has been adopted by the Tax Court, and by most other circuits that have considered the issue.*

The strong proof rule is premised on the theory that the adverse interests of buyer and seller will tend to result in an agreement that adequately reflects the realities of the sale, and the belief that this agreement should not be reshaped by a court after the fact. However, the strong proof rule, unlike the harsher Danielson rule, "permits looking behind the allocation in cases of strong prof that these counterbalancing motivations do not exist."** This standard is also thought to increase the predictability of tax treatment and to preserve the legitimate expectations of the parties to a covenant.

In view of the repeal of the preference for long term capital gains by the Tax Reform Act of 1986, it can be expected that few cases will arise after repeal in which it will be appropriate to apply the strong proof test.

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*Maseeh v. Commissioner, 52 T.C. 18 (1969); Hamlin's Trust v. Commissioner, supra; Sonnleitner v. Commissioner, supra; Harvey Radio Laboratories, supra.

**Clesceri, supra.
VI. TREATMENT OF CONTINGENT PURCHASE PRICE FOR STOCK UNDER SECTIONS 1274, 1275 AND 453

A. Scope

Consideration for the sale of stock may be given in the form of a debt instrument. Sections 163(e) and 1271 through 1275 of the Code apply to debt instruments. Debt instruments are defined as any bond, note, certificate, or other indebtedness including all rights to deferred payments under a contract whether or not evidenced by a formal instrument.* If the face amount of a debt instrument (the stated redemption price at maturity) exceeds its original issue price, the debt instrument bears original issue discount (OID).** Section 1272 requires the holder of an obligation issued at a discount to report OID as it accrues over the instrument's term. Section 163(e) allows the issuer of the instrument to deduct OID accruals, subject to the usual limitations on the deductibility of interest.

Where a debt instrument is given in exchange for property, Section 1274 may apply to the transaction. The purpose of Section 1274 is to determine the issue price of the debt instrument and thus, the purchase price for the property sold. This price is used to determine the seller's gain on the sale and the purchaser's basis in the acquired property.*** Additionally, if Section 1274 is applicable to a debt instrument, a portion of any deferred payments will be recharacterized as interest in the form of OID. Accordingly, this provision, in effect, allocates deferred purchase price payments under a debt instrument between principal and interest. The interest portion of the payments is currently deductible by the issuer of the instrument (i.e., the purchaser) and is currently includable in the seller's income as ordinary income. The principal portion of the payments constitutes additional basis to the purchaser in the acquired property.

Moreover, where a sale occurs and a portion of the purchase price is paid after the close of the taxable year in which the sale occurs, the seller may report income from the sale on the installment basis as provided in Section 453 of the Code. Under this method, a portion of the

*See Prop Reg. § 1.1275-1(b).
**See Section 1273(a)(1).
***See Sections 1001(a) and 1012.
payments received in each year is treated as gain and a portion of the payments is treated as return of capital (i.e., recovery of the seller's basis in the property). This section examines the Section 1274 rules affecting deferred and contingent payments under a debt instrument, and the interaction between those rules and installment sale treatment under Section 453.

B. Applicability and Operation of Section 1274

Generally, Section 1274 is applicable to debt instruments given as consideration for the sale or exchange for property where (1) the stated redemption price at maturity exceeds either the stated principal amount or the imputed principal amount of the instrument and, (2) some or all of the payments under the instrument are due more than 6 months after the date of the sale or exchange.* Where a debt instrument has adequate stated interest, the issue price of the instrument is the stated principal amount and Section 1274 has no application.** Where interest on a debt instrument is either unstated or inadequate, the issue price of the instrument is an imputed principal amount, which is defined as the sum of the present values of all payments due under the debt instrument discounted by the applicable federal rate (AFR).*** Thus, Section 1274 operates to determine the issue price of a debt instrument which either (1) does not call for adequate stated interest or, (2) has adequate stated interest which is not unconditionally payable at a fixed rate at least annually.**** If the interest is inadequate, Section 1274 operates to recharacterize a portion

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*See Section 1274(c)(1). There are a number of exceptions to the application of Section 1274. It does not apply, for example, to notes issued in (1) a sale where the total of all payments is less than $250,000; (2) a sale of the seller's principal residence; (3) a sale of a farm by an individual or small business entity for less than $1 million or (4) a sale of a patent for a price contingent on usage. See Sections 1274(c)(3)(A) through (F). See also, Lokken, "The Time Value of Money Rules", 42 Tax Law Review No. 1, (Fall 1986), (hereafter "Lokken") at pg. 85. Moreover, Section 1274 does not apply to any situation where either the debt instrument itself, or the property for which it is exchanged, is publicly traded. See Section 1273(b)(3) under which the issue price for a publicly traded debt instrument given in exchange for property, or a non-publicly traded debt instrument given in exchange for publicly traded property is the fair market value of the property.

**See Section 1274(a)(1).

***See Sections 1274(b)(1), (b)(2) and (d). There are three AFR's, for short-term, mid-term, and long-term obligations, respectively. Each of the AFR's is an average of the original yields of recent federal borrowings of comparable terms.

****A debt instrument is tested under Section 1274(c)(2) and Prop. Reg. § 1.1274-2, to determine whether it bears adequate stated interest. Generally, in order to be adequate, the stated interest must equal or exceed the AFR compounded semiannually.
of the stated principal as imputed interest which is treated as OID that both parties to the instrument must recognize as it accrues on a constant interest basis over the life of the instrument. If interest is adequate but not unconditionally payable at a fixed rate at least annually (e.g., where the interest is payable at the maturity date), Section 1274 operates to require the parties to recognize the interest as it accrues on a constant interest basis.

C. Contingent Payments

1. Applicability of Section 1274

Contingent payments to which Section 1274 applies are defined in Prop. Reg. § 1.1275-4(a) and (b), and are governed by Prop. Reg. § 1.1275-(4)(c) or (d). The regulations define contingent payment by excluding from the definition (a) payments that may be impaired by insolvency or default; (b) payments of interest at a variable rate where the rate is determined by reference to an objective index and the instrument meets several other requirements imposed by a separate set of rules for variable instruments;** and (c) payments that are contingent only as to time (i.e., where the amount of total principal is fixed, during the instrument's term, the outstanding balance bears interest (payable or compounded at least annually) at a rate that either is fixed by the instrument or is variable with an objective index, and in the case of an instrument issued in a sale or exchange of non-publicly traded property, stated interest is adequate).*** Moreover, the regulations clearly state that nothing contained therein shall influence whether an instrument which calls for contingent payments is to be classified as debt or equity for federal income tax purposes.**** Contingencies contained in instruments issued by a corporation or partnership may be relevant to the classification of the instrument as debt or equity. However, Section 1274 and the regulations are only applicable to bona fide debt instruments.

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*See Section 1272(a)(1). See also Lokken, at pg. 83.

**See Prop. Reg. § 1.1275-4(b)(1).

***See Prop. Reg. § 1.1275-4(b)(2); Lokken, at pp. 164-165.

****See Prop. Reg. § 1.1275-4(a).
2. **Computation of Issue Price of Instrument**

   a. **Treatment of Noncontingent Payments**

      If an instrument exchanged for property calls for both contingent and noncontingent payments, Section 1274 is first applied to the noncontingent payments as though they were the only payments under the instrument. The adequacy of interest is tested under the general rules by considering only the noncontingent payments and any stated interest on those payments. If the stated interest is inadequate, Section 1274 applies to the determination of the issue price of the noncontingent principal and interest thereon. This issue price is used in computing OID and OID accruals, as if the provision for contingent payments did not exist. For example, assume a $3 million three-year instrument issued in exchange for a property that has stated interest of 6% and provision for additional interest of up to 9% per year that is based upon the revenues received by the purchaser from the property, but with no guaranteed minimum total amount. Section 1274 is initially applied to determine the issue price of a $3 million instrument with 6% interest payable annually. The contingent interest is ignored at this point of the computation.

   b. **Treatment of Contingent Payments**

      Generally, where a debt instrument to which Section 1274 applies calls only for contingent payments and bears adequate stated interest, the instrument's characterization of those payments as principal or interest is respected. Accordingly, payments of interest are includable in gross income by the holder and are deductible by the issuer as they become fixed. This general rule does not apply to instruments calling for contingent payments where the stated interest is inadequate. In such a case, the regulations contain two sets of rules for situations where (a) the instrument contains a guarantee of a minimum total amount over a specified time period and, (b) where the instrument does not contain such a guarantee.

      (i). **Contingent Payments With No Guaranteed Minimum Amount**

      If stated interest is inadequate with regard to an instrument calling for contingent payments, but with no total minimum amount guaranteed, the present value of each payment is

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*See Prop. Reg. § 1.1274-4(c)(2).*

**See Prop. Reg. § 1.1275-4(c)(3)(i).**
computed as of the date of the sale or exchange using the AFR of obligations whose terms equal the period from the date of the sale to the date the payment becomes fixed. Prop. Reg. § 1.1275-4(c)(4)

Example 1(iii) illustrates this rule as follows:

Assume an instrument is issued on April 1, 1986, in exchange for property that is subject to Section 1274 and provides for periodic payments of contingent interest. The first payment is in the amount of $100,000 and becomes fixed on December 31, 1986, nine months after the sale. The AFR for instruments maturing in three years or less is 10%. The principal portion of the payment is $93,101 (the present value as of April 1, 1986 of $100,000 due without interest on December 31, 1986, computed with a discount rate of 10%). The purchaser gets $93,101 of additional basis for the property as of December 31, 1986, and if the seller is reporting the sale on the installment basis, it is deemed to receive a payment of $93,101 on the purchase price when the $100,000 payment is made. The remaining $6,899 is interest which must be includable in the income of the seller and deductible by the purchaser in their respective tax years in which December 31, 1986 occurs.

If the instrument contains a fixed or maximum principal amount, the sum of the issue price (computed by taking into account only the noncontingent payments) and the portions of the contingent payments treated as principal, may not exceed that maximum amount. Any amounts in excess of the maximum stated in the instrument are treated entirely as interest.*

(ii). Contingent Payments Due More Than Six Months After Becoming Fixed

If an instrument issued in a sale or exchange of property calls for contingent payments that are due more than six months after they become fixed, the issuer is considered to have issued a separate instrument in the amount of the contingent payment on the date the payment becomes fixed. Prop. Reg. § 1.1275-4(c)(4), Example 2 illustrates the computations required if the contingent payments bear adequate stated interest from the date the payment becomes fixed until the payment date as follows:

Assume an instrument issued on April 1, 1986 provides for a contingent payment of $100,000, which becomes fixed on December 31, 1986, but which is not payable until March 31, 1991. The contingent payment bears interest from December 31, 1986 until maturity at the annual rate of 13% compounded quarterly. This interest is payable only at maturity.

Since the payment is not due within six months of the time it became fixed, the issuer is treated as having issued a new debt instrument on the date the payment becomes fixed, December 31, 1986. This debt instrument has a stated principal amount equal to the amount of the payment that became fixed, $100,000, and matures on the date the payment is due, March 31, 1991. The separate debt instrument has a stated redemption price at maturity of $172,239 (i.e., $100,000 principal plus

$72,239 of deferred interest). Since this interest is not payable currently, it is treated as OID under section 1273 and is subject to accrual over the term of the instrument under section 1272 and the regulations thereunder.

Under Prop. Reg. § 1.1275-4(c)(3)(ii), the $100,000 issue price of the separate debt instrument is treated as principal to the extent of the present value of the payment as of April 1, 1986. Since the contingent payment is due in 4 years and 3 months, the AFR is the mid-term rate of 11% compounded annually. Discounting the payment of $100,000 for nine months (i.e., from December 31, 1986 to April 1, 1986 with a rate of 11% compounded annually) produces a principal portion of the payment equal to $92,471. This amount constitutes additional basis for the purchaser in the property as of December 31, 1986. The remaining portion of the payment, $7,529 is interest which is includable in the income of the seller and deductible by the buyer in their respective tax years in which December 31, 1986 occurs.

Where the contingent payment does not bear adequate stated interest after it becomes fixed, Section 1274 applies to determine the issue price of the deemed separate instrument issued on December 31, 1986 and maturing on March 31, 1991. Thus, the issue price of the separate instrument, i.e., the present value of the $100,000 payment as of December 31, 1986, computed with a discount rate of 11% compounded annually, (the AFR mid-term rate) is $64,177. The difference between the stated redemption price ($100,000) and the issue price ($64,177) is $35,823 which constitutes OID that accrues over the term of the separate instrument, January 1, 1987, through March 31, 1991.

The amount of the contingent payment is deemed to equal the issue price computed above, $64,177. The principal portion of that amount, as computed under Prop. Reg. § 1.1275-4(c)(3)(ii), is the present value, as of the issue date of the original instrument (April 1, 1986) of a payment of $64,177 due December 31, 1986. That amount is $59,345, which is added to the purchaser's basis in the property as of December 31, 1986. The remainder of the $64,177 (i.e., $4,832), is recognized by the parties as of December 31, 1986 as interest.

(iii). Contingent Payments With a Guaranteed Minimum and Without Adequate Stated Interest

Where a debt instrument issued in exchange for property calls for contingent payments that must equal a minimum total amount within a specified period of time, and interest is either unstated or inadequate, the application of Section 1274 to such an instrument is controlled by rules contained in Prop. Reg. § 1.1275-4(d). These rules require (1) the computation of OID on
the guaranteed minimum amount from the issue date of the instrument until the minimum is paid, and (2) subsequent adjustments in the OID accrual calculations as payments are actually made under the instrument.* For example, assume that an instrument is issued on July 1, 1986, in exchange for property, calls for five annual contingent payments (on June 30), based upon the annual income from the property (determined on the preceding March 31), but also requires a minimum payment of $5 million by the end of five year period.** The general rule of Prop. Reg. § 1.1274-4(d)(2)(i) requires the presumption that all of the future payments under the instrument will be made at the last possible date under the terms of the instrument (i.e., at the end of 5 years) and in the least amount permitted (i.e., $5 million). Thus, the initial issue price of the instrument is $2,967,257, the present value as of July 1, 1986, of $5 million due without interest on June 30, 1991, discounted with the appropriate AFR, in this instance the mid-term rate. The difference between the stated redemption price ($5 million) and the initial issue price ($2,967,257) is the tentative computation of OID in the amount of $2,032,742. If no payments are made until the end of 5 years, this amount of OID accrues over the 5 year period as prescribed in Section 1272. The purchaser's basis in the property initially equals the issue price of the instrument plus any down payment or noncontingent consideration.

If annual payments are made under the instrument, the purchaser's basis, the issue price of the instrument and, OID calculations are revised as the payments are made. Under Prop. Reg. § 1.1275-4(d)(2)(ii)(B)(1) and (2), the purchaser's basis is increased by the excess of (a) the present value of any payment including stated interest, as of the instrument's issue date using the appropriate AFR as if the payment were a separate instrument over, (b) the present value of the portion of the payment including stated interest, originally calculated in the initial issue price.*" Assume in the

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*The rules under Prop. Reg. § 1.1274-4(d) apply to the calculation of OID on the minimum amount called for under the instrument. If the payments exceed the minimum, they are treated in the same manner as an contingent payments under an instrument that does not have a guaranteed minimum amount. See Section C.2.(b)(i), above.

**This example is derived from that appearing in Prop. Reg. § 1.1275-4(d)(3), Example (i).

***The first of these present value figures represents the amount of the payment that would have been included in the issue price (and hence the buyer's basis) if it had been known from the outset that this payment would have been made at the end of one year. The second present value figure represents the amount of the payment that was included in the computation of the initial issue price on the assumption that the entire minimum purchase price would be paid at the end of five years. See Lokken at pg. 177.
above example, that the income from the property in the first year was $13 million, so that on June 30, 1987, a payment of $1.3 million was made to the seller. The present value as July 1, 1986, of $1.3 million due on June 30, 1987 (using the short-term AFR) is $1,192,661. The present value as of July 1, 1986 of $1.3 million due on June 30, 1991 (using the mid-term AFR) is $771,487. The difference, $421,174, is added to the purchaser’s basis as of June 30, 1987.

The next step is to compute the adjusted issue price of the original instrument. The adjusted issue price is equal to the present value as of June 30, 1987 of a payment in the amount of $3,700,000 (i.e., the original minimum payment of $5,000,000 less the actual payment of $1,300,000) due on June 30, 1991. Discounting by the appropriate AFR (the mid-term rate), that amount is $2,437,305. The amount of OID allocable to the first accrual period, between July 1, 1986 and June 30, 1987, equals $348,875, which is the sum of the payment actually made at the end of the accrual period, and the adjusted issue price of the debt instrument at the end of the accrual period ($1,300,000 + $2,437,305 = $3,737,305) minus the sum of the increase in the purchaser’s basis as a result of the payment, and the original issue price of the instrument ($421,173 + 2,967,257 = 3,388,430). This process of calculations is repeated as payments are made in subsequent years. The payments are discounted to the date of the determination of the adjusted issue price of the original instrument. So, for example, any payment made on June 30, 1988, would be discounted to June 30, 1987 with the appropriate AFR. These rules only apply to payments up to and including the minimum specified in the instrument and, as previously noted, any payments in excess of the minimum payments would be treated under Section 1274 in accordance with Prop. Reg. § 1.1275-4(c)(3)(ii).

D. **Applicability of Section 453 To Contingent Payments**

Generally, a seller of property realizes the amount of money and the fair market value of other property received in exchange for the property being sold. The seller’s gain, if any, is the excess of the amount realized over the seller’s adjusted basis in the property.

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*See Section 1001(b)*

**See Section 1001(a).**
generally is its cost adjusted for certain items under Section 1016. The purchaser of the property takes a tax basis equal to the amount of money and the fair market value of other property, if any, exchanged for the property.

With certain exceptions, if a sale of property occurs where a portion of the purchase price is paid after the close of the taxable year in which the sale occurs, the seller is required to report income from the sale on the installment method unless the seller elects not to use that method.** Where the sale is reported on the installment method, a portion of the payments received in each year is treated as gain and, a portion of the payments is considered to be return of capital (i.e., recovery of the seller's basis in the property).***

The Temporary Regulations provide that installment sales involving contingent payments also must be reported under the installment method unless the seller elects out of the method.**** A contingent payment installment sale is defined as "a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs."***** For purposes of determining the amount of taxable gain that is reportable in each year under a contingent installment sale, the regulations provide a number of alternative methods for the seller to compute its profit and therefore, to recover its basis. Thus, the regulations provide for different calculations of the seller's gain where: (1) there is a stated maximum selling price payable under the contract for sale;****** (2) no maximum selling price can be determined, but there is a maximum period over which payments may be received under the contingent price agreement;******* (3) neither a maximum stated selling price nor a fixed period may

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*See Section 1012.

**See Sections 453(a), (b), and (d).

***See Section 453(c) and Temp. Reg. § 15A.453-1 et seq.


be determined;* and (4) the property sold is normally depreciable or depletable on the income forecast method, and basis may accordingly be recovered under the income forecast method.**

The Temporary Regulations also provide that the selling price in any contingent installment sale does not include any stated or unstated interest, or any original issue discount.*** Additionally, Temp. Reg. § 15A.453-1(c)(2)(ii) provides rules for recharacterizing portion of installment payments received as interest for purposes of the seller's basis recovery.

Thus, the installment sale rules primarily effect an allocation of the purchase price for property between profit and basis recovery for the seller. Where a debt instrument to which Section 1274 applies is given in exchange for property in a contingent installment sale transaction, that provision generally differentiates between the portion of payments that is treated as principal which the purchaser may add to its basis in the property, and the portion that is treated as interest, which is deductible by the purchaser and includable in income by the seller. For Section 453 purposes, only those portions of the such payments that are considered to be principal may be treated as amounts upon which the seller may compute its profit and the recovery of its basis under one of the various methods provided in the regulations under Section 453.

