Depreciation of Intangibles: An Area of the Tax Law in Need of Change*†

Under the current tax law, depreciation of many purchased intangibles is denied on the theory that they have an unlimited, or at least indeterminate life. However, many taxpayers have challenged this theory on the ground that intangibles are subject to wear and tear like any other asset. The imprecise factual nature of this issue has lead to unnecessary complexity and uncertainty, a great burden on the courts, and unfair treatment of taxpayers. A legislative solution to these problems is needed.

I. Introduction

The depreciation of purchased intangible assets has been a troublesome issue since the early days of federal income taxation. In May, 1993, the House of Representatives passed a bill that should, if enacted, eliminate much of the current controversy and complexity in this area of the tax law by allowing depreciation of goodwill and most other intangibles over a statutory life of fourteen years.[1] This

* The author wishes to dedicate this Comment to his wife, Robby, for her constant support and to thank Professor Lester Snyder for his valuable comments and recommendations.

† On August 10, 1993, shortly before publication of this Comment, President Clinton signed into law H.R. 2264, which includes a provision allowing depreciation of 100 percent of the cost of purchased intangibles over a fifteen year period. The information and analysis contained in this Comment is based on the law as it existed prior to the enactment of H.R. 2264.

1. H.R. 2264, 103d Cong., 1st Sess. (1993). The provision allowing depreciation of intangibles was introduced as part of H.R. 13, a tax simplification bill. *See* H.R. 13, 103d Cong., 1st Sess. (1993). The intangibles provision of H.R. 13 was later added to H.R. 2264, the "Omnibus Budget Reconciliation Act of 1993," which was passed by the House of Representatives on May 27, 1993. On June 25, 1993, the Senate passed S. 1314, its version of H.R. 2264. Regarding the intangibles provision, S. 1314 is identical to the House version of H.R. 2264, with two exceptions. First, under S. 1314, only 75% of the cost of purchased intangibles would be depreciable over the 14 year statutory life. Second, S. 1314 would allow a special 60-month amortization period for intangibles acquired in the purchase of a computer software business.

The intangibles provision of H.R. 13 is identical to the provision included in H.R. 11, a bill passed by both the House and the Senate in 1992, but vetoed by President Bush. *See* discussion of H.R. 13 *infra* note 121. *See also* Bennett Minton, *Rosty Reintroduces Simplification Bill as Congress Gets Organized*, 58 TAX NOTES 111, 111 (1993). In vetoing H.R. 11, Bush criticized many of the bill's provisions. He did not, however, express any

Comment will not only analyze the bill passed by the House, but will also examine the problems arising under the current law and address possible solutions to these problems.

In general, a taxpayer is allowed, under section 167 of the Internal Revenue Code (the Code), to claim a depreciation deduction for "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business."[2] The regulations under section 167 indicate that no depreciation deduction is allowed for intangible assets that do not have a limited life. Those regulations also specifically prohibit a depreciation deduction for goodwill.[3] The Internal Revenue Service (the Service) and the courts have adopted the position that a depreciation deduction can be secured for intangible assets only if the taxpayer establishes that the asset: "(1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy."[4] As this Comment will discuss in detail, these two requirements are normally the focal point of litigation involving the depreciation of intangibles.

Much of the controversy surrounding the depreciation of intangibles involves tax policy considerations. One of the standards used to judge a system of income taxation from a policy standpoint is fairness. In attempting to attain this goal of fairness, our tax system relies on two propositions: (1) that taxation of people according to their ability to pay is fair and (2) that income is a good measure of ability to pay.[5]

Fairness is generally divided into two categories, horizontal and vertical equity.[6] The principle of horizontal equity, on which this Comment will focus, means that fairness dictates that similarly situated people should be taxed alike.[7] On the other hand, a tax law that

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objections to the intangibles provision. Bennett Minton, *Bush Vetoes Tax Bill on "The Day After,"* 57 TAX NOTES 703, 703 (1992).

2. I.R.C. § 167(a) (1988). All textual references to section numbers in this Comment refer to the Internal Revenue Code.

3. Treas. Reg. § 1.167(a)-3 (as amended in 1986).

4. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1250 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). *See* discussion of *Houston Chronicle infra* note 60 and accompanying text. *See also* Rev. Rul. 74-456, 1974-2 C.B. 65; Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670, 1683, (1993). *See* discussion of *Newark Morning Ledger Co. infra* notes 46-47, 61-62 and accompanying text.

5. WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 16 (8th ed. 1990). In this context, "income" is an approximation of the accounting concept of net income (i.e., receipts less the cost of producing those receipts).

6. *Id.* at 19. Vertical equity refers to the concept that as one's income rises the percentage of income that one pays as a tax should also rise. *Id.* at 20. This Comment will not analyze vertical equity.

7. *Id.* at 19.

treats similarly situated taxpayers differently, will probably be perceived as unfair and will likely lead to increased taxpayer noncompliance.[8]

The principle of horizontal equity is violated by the current tax law's denial of depreciation deductions for purchased intangibles. This inequity can be illustrated by comparing two hypothetical taxpayers. The two taxpayers (*A* and *B*) each purchase a manufacturing business for $10,000,000. Taxpayer *A* is able to allocate $9,000,000 of the purchase price of the manufacturing business to depreciable tangible assets (e.g., plant, machinery, and equipment) according to their fair market value and $1,000,000 to nondepreciable intangibles (e.g., goodwill, and customer lists).[9] Assume that Taxpayer *B* purchases a similar, though slightly smaller, business which has tangible assets with a fair market value of $7,000,000. The remaining $3,000,000 of the purchase price of *B*'s business is allocated to nondepreciable intangibles.[10] Assume further that the average useful life of the tangible assets is ten years for both taxpayers. Therefore, *A* would be eligible for an annual depreciation deduction of $900,000 over the following ten years (assuming straight-line depreciation). At an assumed marginal tax rate of forty percent, the depreciation deductions would reduce *A*'s annual tax bill by $360,000.

B, on the other hand, faces a substantially less desirable tax situation. *B* would be allowed annual depreciation on tangible assets of $700,000 which, at the same marginal tax rate of forty percent, would result in a tax benefit of only $280,000. If we assume that both *A* and *B* have identical taxable incomes before depreciation, we

8. George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179, 1182-83 (1987).

9. Under I.R.C. § 1060 (1988) and Temp. Treas. Reg. § 1.1060-1T(d) (1988), the purchaser of a business must allocate the purchase price to tangible assets and certain specifically identifiable intangibles according to their relative fair market values. Any remaining purchase price is allocated to "intangible assets in the nature of goodwill and going concern value." Temp. Treas. Reg. § 1.1060-1T(d)(2)(iii).

10. For purposes of this example, assume the business purchased by *B* has a history of generating approximately the same annual net income as the business purchased by *A* and that similar earnings are expected to continue in the future for each business. As a result, a buyer is willing to pay $10,000,000 for either business, even though *A*'s business has a greater investment in tangible assets.

The difference between the total value of each business and the value of each business' tangible assets is allocated to nondepreciable intangibles, as required by I.R.C. § 1060. *See supra* note 9. *See also infra* note 34 for an example of how past earnings and projected future earnings are utilized in valuing a business.

can logically conclude that each has the same ability to pay.[11] However, because of the nondepreciability of goodwill and other intangibles in the nature of goodwill (e.g., customer lists and customer structure), *B*'s annual tax bill is $80,000 higher than *A*'s. Over a ten-year period, *B* would pay $800,000 more in income taxes than *A* solely because *B* has a larger investment in nondepreciable intangibles.

Although an extremely simplified example, the above comparison illustrates how the current tax treatment of intangibles leads to inequity in the treatment of similarly situated taxpayers. As a result of the unfair treatment of purchasers of intangibles, the tax system has been burdened with considerable controversy and litigation, which leads to unnecessary complexity and inefficiency in the administration of the tax law.[12]

After general discussions of depreciation and intangible assets, this Comment will examine similar inequities created by the current tax law in three areas: (1) tangible assets versus intangible assets, (2) internally developed versus purchased intangibles, and (3) specifically identifiable intangibles versus goodwill. This Comment will then analyze additional justifications (other than correcting inequity) for the depreciation of goodwill and other intangibles in the nature of goodwill. Finally, this Comment will examine possible solutions to these problems with a view toward significantly reducing the inequity and controversy arising under the current law.

II. Business Expenditures and Depreciation, In General

For income tax purposes, business expenditures can be classified as either currently deductible or capital expenditures. Currently deductible expenditures are those incurred by a taxpayer in a trade or business that may be deducted on the current year's tax return. To

11. A basic assumption in this example is that the purchased intangibles are actually used up over ten years in the production of income for both taxpayers. Therefore, depreciation of these intangibles over that period of time, if depreciation were allowed by the tax law, would be appropriate. As this Comment will examine, however, estimation of a useful life for some intangibles (particularly goodwill) is much more difficult than for most tangible assets. The inequity in this situation is mitigated to some degree, though, by the different treatment given to the costs of replacing tangible assets at the end of their useful lives versus the costs of replacing intangibles. For example, the cost of buying a new machine to replace one that is worn out must be depreciated over the new machine's useful life, while the cost of advertising to replace fading goodwill is generally deductible immediately. The different treatment of tangible and intangible assets is examined in more detail *infra* Part IV.

12. Reducing controversy and litigation in this area was the principal basis for including the intangibles provision in H.R. 11 and H.R. 13. *See* H.R. 11, 102d Cong., 2d Sess. (1992); H.R. 13, 103d Cong., 1st Sess. (1993); H.R. Rep. No. 631, 102d Cong., 2d Sess. 210 (1992); S. Rep. No. 300, 102d Cong., 2d Sess. 22-23 (1992). *See also supra* note 1 and *infra* note 125. The cases discussed *infra* Part IV provide examples of the complex litigation arising under the current law.

be currently deductible, an expenditure must be an "ordinary and necessary expense[ ] paid or incurred during the taxable year in carrying on a trade or business."[13]

In general, a current deduction is not allowed for the cost of acquisition of property (either tangible or intangible) "having a useful life substantially beyond the taxable year."[14] Capitalization may be required, however, even though a specific asset is not acquired, if the expenditure provides benefits to the taxpayer over a period beyond the current taxable year.[15] On the other hand, certain expenditures,

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13. I.R.C. § 162(a) (1988).

14. Treas. Reg. § 1.263(a)-2 (as amended in 1987). *See also* I.R.C. § 263A (1988), which requires capitalization not only of direct costs of acquisition or construction of assets but also an allocable portion of related indirect costs.

Although decided before the enactment of § 263A in 1986, the case of Commissioner v. Idaho Power, 418 U.S. 1 (1974), provides an example of the capitalization of indirect costs required by § 263A. In *Idaho Power*, the taxpayer attempted to take a current depreciation deduction on equipment that it used to construct its own facilities. The Court denied the deductions and required the taxpayer to capitalize the depreciation as part of the construction cost of the facilities along with direct costs, such as materials and labor.

15. *See, e.g.*, Fall River Gas Appliance Co. v. Commissioner, 349 F.2d 515 (1st Cir. 1965). The taxpayer was denied current deduction of costs to install leased gas appliances in customers' homes that would generate rental income over a period of future years. The court required amortization of the expenditures over twelve years.

See also INDOPCO, Inc. v. Commissioner, 112 S.Ct. 1039 (1992), *aff'g* National Starch and Chem. Co. v. Commissioner, 918 F.2d 426 (3d Cir. 1990). The Court required a target corporation to capitalize investment banking fees and other expenses paid in connection with the acceptance of a friendly takeover bid because the Tax Court found that the acquisition provided long-term benefits to the target corporation's existing business. *INDOPCO* has the potential to significantly change the relationship between deductions and capital expenditures.

Before *INDOPCO*, the courts relied on the test utilized in Commissioner v. Lincoln Sav. and Loan Ass'n, 403 U.S. 345 (1971) in concluding that expenditures were deductible as long as a "separate and distinct asset" was not created. However, in *INDOPCO*, the Court stated that *Lincoln Savings* does not stand for the proposition that "only expenditures that create or enhance separate and distinct assets are to be capitalized under section 263." 112 S.Ct. at 1044. The Court apparently held that costs that create some significant future benefit must be capitalized. George B. Javaras & Todd F. Maynes, *Business Expansion and Protection in the Post-*INDOPCO World, 55 TAX NOTES 971, 972 (1992).

The Court noted "the 'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to a claimed deduction is on the taxpayer.' " *INDOPCO*, 112 S. Ct. at 1043 (quoting Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943)). The Court then concluded that "deductions are exceptions to the norm of capitalization." *Id.* at 1043. This broad language has caused concern among some taxpayers that the Service may challenge deductions for advertising, employee training and repairs, and maintenance expenses, all of which often provide both future and current benefits. John W. Lee, *Doping Out the Capitalization Rules After INDOPCO*, 57 TAX NOTES 669, 669 (1992).

such as advertising and research and development, are currently deductible even though they may provide benefits in future tax years.[16]

A taxpayer will generally seek to deduct the cost of acquiring or constructing property by taking depreciation or amortization deductions over the property's estimated useful life or recovery period, as allowed by sections 167 and 168.[17] The estimated useful life of an asset is defined in the regulations as "the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business."[18] From an economic point of view, the purpose of tax depreciation is to attempt to measure the annual decline in value of the taxpayer's depreciable property that results from use in producing income for the taxpayer's business over the asset's useful life.[19]

Attempts to measure the annual economic decline in value of tangible property, however, have largely been abandoned under the current depreciation regime, the Accelerated Cost Recovery System (ACRS).[20] Under ACRS, which was adopted in 1981, the cost of tangible property is recovered through depreciation deductions over predetermined periods that are unrelated to, and generally shorter than, the useful lives mandated under the previous depreciation system.[21] In an effort to simplify depreciation, Congress determined

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In Rev. Rul. 92-80, 1992-39 I.R.B. 8, the Service held that *INDOPCO* "does not affect the treatment of advertising costs as business expenses which are generally deductible under section 162." The Service has not yet taken an official position on the effect of *INDOPCO* on the deductibility of business expansion costs, repairs and maintenance, employee training costs, and other expenditures that potentially provide future benefits. Service representatives, however, have stated that *INDOPCO* did not change the standards for distinguishing deductible expenses from capital expenditures, except to overrule the "separate and distinct asset" doctrine. Lee, *supra*, at 670.

16. Advertising expenditures are generally deductible as "ordinary and necessary" business expenses under I.R.C. § 162 (1988) on the ground that allocation between current deductions and capital outlays is not feasible. For a discussion of the tax treatment of advertising expenses, see BORIS I. BITTKER, FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS ¶ 20.4.5 (1989 & Supp. 1992). I.R.C. § 174 (1988) allows current deduction of research and experimental expenditures.

17. I.R.C. § 167 (1988) governs depreciation of tangible assets acquired before January 1, 1981, and intangible assets. I.R.C. § 168 (1988) governs depreciation of tangible assets acquired on or after January 1, 1981.

The term "depreciation" can be used to refer to the deduction of the cost of all property, both tangible and intangible, over its useful life. The term "amortization" is often used to describe depreciation of intangible assets. This Comment will use the term "depreciation" for both tangible and intangible property.

18. Treas. Reg. § 1.167(a)-1(b) (as amended in 1986).

19. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS ¶ 6.08, at 142 (6th ed. 1991).

20. *See* further discussion of ACRS *infra* notes 40-41 and accompanying text.

21. EARL F. DAVIS & CAROLINE D. STROBEL, CAPITAL COST RECOVERY AND LEASING § 1.10 (1987). The Asset Depreciation Range System (ADR) was used for assets acquired from 1971-1980. ADR gave taxpayers more freedom to select useful lives than under ACRS. ADR was intended to simplify depreciation but actually proved to be quite complex because of detailed accounting requirements. *See* MICHAEL J. GRAETZ, FEDERAL INCOME TAXATION, PRINCIPLES AND POLICIES 395 (2d ed. 1988).

that the new cost recovery system should deemphasize useful life, which was an uncertain and subjective concept that often caused lengthy and unproductive controversies between taxpayers and the Service.[22]

One of the basic premises of the tax law is that income and deductions must be accounted for under a method that clearly reflects the net income of the taxpayer for each tax year.[23] By requiring the taxpayer to defer depreciation deductions to future years, rather than deducting the cost of assets in the year of acquisition or construction, the tax law attempts to match deductions for the business use of depreciable assets against the income those assets produce. The validity of the matching concept had been recognized by the courts.[24]

III. INTANGIBLE ASSETS, IN GENERAL

An ongoing business will generally use two broad categories of assets in producing income - tangible assets and intangible assets. Tangible assets are those that have a physical existence, such as cash, real estate and equipment.[25] Accounts receivable are also considered tangible assets, although they do not appear to have a physical existence.[26] An intangible asset is "[a] nonphysical, noncurrent asset which exists only in connection with something else, such as the goodwill of a business."[27] Intangible assets can also be described as "[a]ll competitive advantages, developed or acquired, having a value derived principally from use in the taxpayer's trade or business, which enable the taxpayer to generate revenue and earn income in excess of the revenue and income attributable specifically to tangible assets."[28] In addition to the goodwill of a business, other examples of

22. DAVIS & STROBEL, *supra* note 21, §§ 1.09-1.10.

23. *See, e.g.*, I.R.C. § 446(b) (1988); CHIRELSTEIN, *supra* note 19, at 215; GRAETZ, *supra* note 21, at 853.

24. *See, e.g.*, Massey Motors v. United States, 364 U.S. 92, 106 (1960). To more clearly reflect the taxpayer's net income for the taxable years involved, the court required the taxpayer to recompute depreciation on vehicles used in the business by subtracting salvage value from the cost of the vehicles, resulting in a more accurate estimate of the assets' annual decline in value. *Id.* at 107. *See also* Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir. 1965). The taxpayer was denied a deduction for employee training costs incurred before the taxpayer had begun business because such costs would generate income in future years. *Id.*

25. BLACK'S LAW DICTIONARY 1456 (6th ed. 1990).

26. *Id.*

27. *Id.* at 808-09.

28. Martin J. Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 TAX LAW. 251, 258 (1975).

intangible assets are patents, copyrights,[29] and customer lists.

A business' intangible assets can be obtained through internal development or by purchasing the intangible assets of another business. A business may internally develop intangible assets in a variety of ways, such as advertising, research and development,[30] establishing a marketing structure, and developing a capable management and labor force.[31] Purchased intangibles are normally acquired when a taxpayer buys the assets of an ongoing business and pays more than the fair market value of the acquired business' tangible assets. The taxpayer must allocate this excess purchase price among the various intangibles acquired.[32] These intangibles generally consist of two types: (1) specifically identifiable intangibles, such as patents, copyrights, contracts, and covenants not to compete, and (2) goodwill (which often includes intangibles related to goodwill, such as customer lists or customer structure), which is the residual remaining after allocation to all tangible assets and specifically identifiable intangible assets.[33]

Although section 1060 requires that the value of goodwill be determined by the residual method, conceptually, goodwill is the present value of the projected future excess earnings of the purchased business.[34] The parties involved in the purchase and sale of a business frequently find computations of earning potential useful in their

29. Treas. Reg. § 1.167(a)-3 (as amended in 1986) states that patents and copyrights are depreciable because they have limited useful lives. *See infra* notes 51-59 and accompanying text for a discussion of depreciation of certain specifically identifiable intangibles.

30. *See* discussion of research and experimental expenditures *infra* note 83.

31. Gregorcich, *supra* note 28, at 256.

32. I.R.C. § 1060(a) (1988); Temp. Treas. Reg. § 1.1060-1T(d) (1988).

33. Gregorcich, *supra* note 28, at 258-64. *See infra* notes 70-79 and accompanying text for a discussion of the different conceptual notions of goodwill.

34. GLENN A. WELSCH ET AL., INTERMEDIATE ACCOUNTING 519 (5th ed. 1979). The excess earnings approach is illustrated in the following example, which is adapted from the materials in WELSCH, ET AL., at 521-22:

Assume the following facts:

1. Taxpayer A purchases the net assets* of an ongoing business. The net assets have a fair market value of $10,000,000.
2. The normal expected rate of return on investment in the industry is 12%.
3. Based on the previous ten years' actual earnings, Taxpayer A projects that the purchased business will have annual earnings of $2,000,000 for the next ten years.
4. Any projected earnings in excess of the normal industry rate of return are discounted to present value at an annual rate of 15% (15% is used rather than 12% to reflect the greater risk of not earning above the normal rate).

* Net assets includes all purchased tangible assets and specifically identified intangibles, (e.g., patents and copyrights), less liabilities assumed by Taxpayer A.

negotiations.[35] Additionally, two other approaches to goodwill are customer structure and going concern value. These approaches, however, are primarily definitional in nature and are not useful in determining a value for goodwill.[36]

IV. INEQUITIES IN THE CURRENT TAX LAW

A. *Intangible Versus Tangible Assets*

As indicated above, a taxpayer may take depreciation deductions under section 167 for assets which have a limited useful life that can be estimated with reasonable accuracy. In other words, an asset is depreciable if it wears out over a reasonably estimable period of time, as would clearly be true for a building or a piece of equipment.[37] Reasonable accuracy is all that is required in estimating an asset's useful life.[38] The Code presumes that all tangible assets are subject to wear and tear that will use up their value to the taxpayer over some period of time.[39] In fact, under ACRS, which governs depreciation of tangible property placed into service after 1980, a taxpayer is not required to make a reasonably accurate estimate of the useful life of tangible assets to obtain a depreciation deduction. Instead, ACRS assigns a useful life to tangible assets based on the type of property acquired.[40] For example, the cost of nonresidential real property must be depreciated over a recovery period of 31.5

Projected future average annual earnings of the purchased business	$2,000,000
Expected annual return on net assets at normal rate of return for the industry ($10,000,000 x 12%)	1,200,000
Projected annual excess earnings	$ 800,000
Annual excess earnings (computed above)	$ 800,000
Projected period of excess earnings	10 years
Value of Goodwill (i.e. present value of projected excess earnings for ten years at 15% capitalization rate)	$4,015,015

35. *Id.* at 520.
36. J. Bruce Donaldson, *Goodwill and Other Intangibles in Business Acquisitions*, 31 INST. ON FED. TAX'N 291, 294-96 (1973). *See also infra* notes 70-79 and accompanying text for further discussion of the conceptual approaches to goodwill.
37. CHIRELSTEIN, *supra* note 19, ¶ 6.08, at 137.
38. *See, e.g.*, Houston Chronicle Publishing Co. v. United States, 481 F. 2d 1240, 1253-54 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), where the court stated, "Extreme exactitude in ascertaining the duration of an asset is a paradigm that the law does not demand."
39. BITTKER, *supra* note 16, ¶ 23.2.6, at 23-35 to 23-36.
40. I.R.C. § 168(c) (1988). Under ACRS, the term "recovery period" replaces the

years, regardless of its estimated useful life.[41]

While the Code allows depreciation for all tangible assets used in a trade or business under the presumption that the value of all such assets will be used up over time, the same cannot be said for intangible assets. Depreciation deductions for intangible assets are much more difficult for a taxpayer to obtain. In fact, ACRS does not apply to intangible property.[42] A taxpayer, therefore, must find authority for depreciation of intangibles in section 167.[43] The regulations prescribe that an intangible asset may be depreciated only if it is useful in a taxpayer's business for "a limited period, the length of which can be estimated with reasonable accuracy . . . [e]xamples are patents and copyrights."[44] To depreciate an intangible asset, the taxpayer has the burden of proving that the asset has a limited useful life that can be measured with reasonable accuracy, as well as proving that the asset has an "ascertainable value separate and distinct from goodwill."[45]

The rationale used by the courts for denying depreciation is that intangibles in the nature of goodwill and goodwill itself are not wasting assets.[46] The economic value of such intangibles is assumed by the courts to be relatively permanent.[47] Given the traditional aim of

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concept of useful life. The taxpayer no longer estimates a useful life for depreciable assets. Rather, each asset is classified in one of eight recovery classes with recovery periods ranging from 3 to 50 years. *Id.* § 168(c)(1). *See also* I.R.C. § 168(e) (1988). In addition, the term "cost recovery" is often used to describe depreciation under ACRS.

41. I.R.C. § 168(c)(1) (1988).

42. I.R.C. § 168(a) (1988). Section 168 applies specifically to tangible property.

43. BITTKER, *supra* note 16, ¶ 23.2.6, at 23-35.

44. Treas. Reg. § 1.167(a)-3 (as amended in 1986).

45. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1251 (5th cir. 1973), *cert. denied*, 414 U.S. 1129 (1974); Rev. Rul. 74-456, 1974-2 C.B. 65; *see also* Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670, 1683 (1983).

46. *See, e.g*, Richard Miller and Sons v. United States, 537 F.2d 446, 452 (Ct. Cl. 1976). In deciding whether insurance expirations purchased by the taxpayer from a competitor insurance agency were depreciable, the court stated "[t]he most important criterion is whether in fact it is a wasting asset". *See also* Newark Morning Ledger Co. v. United States, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993). The subscriber lists acquired by the taxpayer in the purchase of a newspaper were not considered wasting assets by the Court of Appeals because customers leaving the newspaper who were included in the purchased subscriber lists were continually replaced by new customers who were attracted by the quality and reputation (i.e., goodwill) of the newspaper. In reversing, however, the Supreme Court rejected the Court of Appeals' position and held that the cost of the purchased subscribers was depreciable. *Newark Morning Ledger Co.*, 113 S. Ct. at 1681. *See* further discussion *infra* note 47.

47. *See, e.g.*, *Houston Chronicle*, 481 F.2d at 1248 ("[T]he economic value of a taxpayer's continuing goodwill within his field of operations is seen as an ongoing asset that fluctuates but does not necessarily diminish."). *But see Newark Morning Ledger Co.*, 113 S. Ct at 1679-80. While the Court in *Newark* did not state that goodwill itself is depreciable, it did hold that certain intangibles that are closely related to goodwill may be depreciable. The Court also held that whether customer-based intangibles, such as purchased newspaper subscribers, can be separated from goodwill and depreciated is a question of fact. *Id. See* further discussion of depreciation of goodwill-related intangibles *infra* notes 60-66 and accompanying text.

tax depreciation to measure the annual decline in value of assets used in the taxpayer's business,[48] courts will likely deny depreciation deductions for any asset that is presumed not to diminish in value over time.[49]

If the presumption of an unlimited life for such intangibles is incorrect, however, an inequitable distinction is created if the law allows depreciation of tangible assets while denying depreciation of intangibles. The purpose of the succeeding sections of this Comment is to show that intangibles in the nature of goodwill do diminish in value over time and should, therefore, be depreciable for tax purposes.

B. Specifically Identifiable Intangibles Versus Goodwill and Other Intangibles in the Nature of Goodwill

An inequity similar to the one just described results from the willingness of the tax law to allow depreciation of certain specifically identifiable intangibles while denying depreciation of goodwill and certain other intangibles, such as customer lists and customer structure. When a taxpayer purchases the assets of an ongoing business, he must allocate the purchase price among tangible assets, specifically identified intangibles, and goodwill.[50] Certain specifically identifiable intangibles have a useful life that generally is relatively easy to identify. Without question, depreciation is available when an intangible can be readily shown to have a limited useful life, such as a patent or copyright.[51] For example, a patent may be depreciated over its seventeen year federally protected life as long as the patent holder uses it in his trade or business or for the production of income.[52] Another typical example of a depreciable intangible is a contract right acquired by the purchaser of a business (e.g., a contract to provide services for a customer or a building lease with favorable terms). If the life of the contract covers a specific period of time, the contract right can be depreciated over that period.[53]

48. CHIRELSTEIN, *supra* note 19, ¶ 6.08, at 142.
49. The Code, however, has abandoned, to some degree, attempts to measure the annual decline in value of tangible and intangible assets in favor of a cost recovery approach. *See* discussion of ACRS *supra* notes 20-22 and 40-41 and accompanying text and start-up and organizational expenditures *infra* notes 104-19 and accompanying text.
50. I.R.C. § 1060(a) (1988); Temp. Treas. Reg. § 1.1060-1T(d) (1988).
51. Richard Miller and Sons, Inc. v. United States, 537 F.2d 446, 452 (Ct. Cl. 1976).
52. Gregorcich, *supra* note 28, at 259.
53. *Id.* at 261. If, however, acquired customer relationships are terminable at will

One of the most common specifically identified intangibles arising out of the purchase and sale of a business is a covenant not to compete. A purchaser paying a premium for goodwill in the acquisition of an ongoing business will typically demand a covenant not to compete from the seller so that he can be assured of obtaining the benefits of that goodwill.[54] Courts have generally allowed taxpayers to allocate part of the purchase price of a business to an amortizable noncompete covenant if the parties to the purchase and sale agreed upon the amount allocated and the allocation reflected economic reality.[55] In determining the outcome of cases, the courts have examined the following factors:[56] tax polarity,[57] intent and ability to compete,[58] and negotiations between the parties.[59]

In acquiring the assets of an ongoing business, the taxpayer may acquire intangible assets that are separately identifiable, but do not have such readily ascertainable useful lives as patents, contracts, or covenants not to compete. Taxpayers have consistently attempted to depreciate customer lists or similar assets that are acquired in the purchase of an ongoing business on the theory that customers' patronage will continue for a limited period of time. Before the *Houston Chronicle* decision in 1973, courts generally held that such

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by customers, depreciation of the intangible asset (sometimes referred to as customer structure) is often denied by the courts. *See, e.g.*, Golden State Towel and Linen Serv., Ltd. v. United States, 373 F.2d 938, 944 (Ct. Cl. 1967). The court disallowed a deduction for the loss of a customer that was included in a customer list acquired as part of the purchase of a going business. The court stated that "a purchased terminable-at-will type of customer list is an indivisible business property with an indefinite, nondepreciable life, indistinguishable from - and the principal element of - goodwill." *But see* Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670 (1993) (discussed *supra* notes 46-47 and *infra* notes 61-62).

54. Gregorcich, *supra* note 28, at 264.

55. Darlene A. Smith, Patrick Hennessee & Clifford Hutton, *Allocating Purchase Price to Assets Regains Importance*, 19 TAX'N FOR LAW. 358, 359 (1991). The amount allocated to the covenant is amortized over the period covered by the agreement, typically five years or less.

56. *Id.* at 360-61.

57. *See, e.g.*, Douglas J. Lemery v. Commissioner, 52 T.C. 367, 376 (1969), *aff'd*, 451 F.2d 173 (9th Cir. 1971). The court disallowed amortization of the amount of the purchase price allocated by the purchaser to a noncompete covenant. Significant to the court was the lack of tax polarity between buyer and seller, which could lead to manipulation of the purchase price allocation to the advantage of both parties. For further discussion of the adverse tax interests of buyer and seller, see *infra* note 117 and accompanying text.

58. *See, e.g.*, Schulz v. Commissioner, 294 F.2d 52, 54 (9th Cir. 1961). The court relied on certain factors in determining that the "purported covenant was in reality a sale of goodwill." Among those factors were that the seller did not wish to compete with the buyers and the seller's lack of technical background and sales contacts.

59. *See, e.g.*, Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962), *reh'g denied*. The purchaser allocated an amount to a covenant not to compete given by the seller. The court found that the covenant was not separately bargained for or paid for and thus was not amortizable. Of significant importance to the court was the fact that the covenant was not discussed by the parties until after the purchase price had been preliminarily agreed upon.

intangibles were nondepreciable as a matter of law under the "mass asset rule."[60] In many cases, taxpayers have undertaken complex statistical studies based on historical, demographic, and other data in attempting to prove the limited life of the asset. Because of the inexact factual nature of estimating the life of a customer list or similar asset and proving a value separate and distinct from goodwill, taxpayers' attempts to depreciate such assets are routinely challenged by the Service, often leading to time-consuming and costly litigation.[61]

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60. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1249 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). The court's holding, which was accepted by the Service in Rev. Rul. 74-456, 1974-2 C.B. 65, essentially superseded the "mass asset rule," which provided that all purchased intangibles in the nature of goodwill (e.g., goodwill, going concern value, customer lists, and trained labor force) are grouped together and treated as a single indivisible asset. The individual intangibles were presumed to have self-regenerating capability and therefore no determinable useful life.

In *Houston Chronicle*, the court allowed the taxpayer to depreciate over five years a newspaper subscription list purchased from a defunct competitor because the taxpayer showed that the list had a value separate and distinct from its competitor's goodwill (because the taxpayer had no intention of continuing to publish the competitor's newspaper) and a limited useful life that could be estimated with reasonable accuracy. The court held that newspaper subscription lists were not nondepreciable as a matter of law.

For cases endorsing the mass asset rule, *see, e.g.*, Golden State Towel and Linen Serv., Ltd. v. United States, 373 F.2d 938, 942 (Ct. Cl. 1967) ("[G]oodwill and customer lists . . . are but one in contemplation of law."); Metropolitan Laundry Co. v. United States, 100 F.Supp. 803, 805 (N.D. Cal. 1951) ("The gradual replacement of old patrons with new ones is not to be regarded as the exchange of old capital assets for new and different ones, but rather as the process of keeping a continually existing capital asset intact.").

61. *See, e.g.*, Newark Morning Ledger Co. v. United States, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993). The taxpayer attempted to depreciate the portion of the purchase price of a newspaper business allocated to an intangible denominated "paid subscribers," which represented the taxpayer's estimate of the future profits to be derived from the at-will subscribers acquired. The Third Circuit Court of Appeals essentially held that certain intangible assets, such as customer-based intangibles, are nondepreciable because they are inseparable from goodwill. The court stated that "[c]ustomer lists are generally not depreciable when acquired in conjunction with sale of . . . a going concern." *Id.* at 568. The Third Circuit's decision conflicts with cases in other circuits, including Donrey, Inc. v. United States, 809 F.2d 534 (8th Cir. 1987) and Colorado Nat'l Bankshares, Inc. v. Commissioner, 60 T.C.M. 771, (1990), *aff'd*, 984 F.2d 383 (10th Cir. 1993), in which taxpayers were allowed to depreciate customer-based intangibles after proving that the assets have value apart from goodwill and reasonably ascertainable useful lives (*see* discussion of *Colorado Nat'l Bankshares infra* and *Donrey infra* note 63). The Supreme Court resolved this conflict by holding in *Newark Morning Ledger* that customer-based intangibles are not nondepreciable as a matter of law.

In *Colorado Nat'l Bankshares*, the court sustained the taxpayer's depreciation deductions for core deposits intangible acquired in the purchase of several banks (core deposits intangible represents the present value of the future stream of net income projected to be generated by utilizing the core deposits acquired on the date a bank is purchased). The taxpayer used sophisticated studies to estimate how long depositors would maintain their accounts at each bank. Based on these studies, the taxpayer was able to show that core

In *Newark Morning Ledger*, although the Supreme Court held that customer-based intangibles are not nondepreciable as a matter of law, the Court also held that the taxpayer must meet a "substantial burden of proving" that the asset has an "ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy."[62] Before the Supreme Court's decision in *Newark Morning Ledger*, however, some courts had denied deductions based on the theory that customer-based intangibles are indistinguishable from goodwill, even though the taxpayer could ascertain a value for the asset and estimate a useful life with reasonable accuracy.[63]

Since *Houston Chronicle*, the outcome of most cases concerning the depreciation of customer-based intangibles has been determined largely by the sophistication of the taxpayer's proof.[64] As a result, an increasing number of taxpayers will benefit from spending the necessary money to develop the level of proof needed to sustain a deduction. This trend will likely engender an ever-increasing amount of controversy and litigation in this area of the tax law.[65]

While taxpayers have been successful in some cases in securing depreciation deductions for certain customer-based intangibles, the courts have routinely denied depreciation of goodwill itself as a matter of law.[66] Depreciation of goodwill is specifically denied by the regulations under section 167.[67] Under the tax law, goodwill is the

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deposits intangibles had ascertainable value separate and distinct from goodwill and useful lives which could be estimated with reasonable accuracy.

62. *Newark Morning Ledger Co.*, 113 S. Ct. at 1683. For examples of other cases before *Newark* in which depreciation of customer-based intangibles was allowed, see Panichi v. United States, 834 F.2d 300 (2d Cir. 1987) (taxpayer bought only a small part of the customer list of an ongoing business and the seller remained in business); *Houston Chronicle*, 481 F.2d 1240 (taxpayer bought the subscriber list of a defunct competitor with no intention of continuing to publish the competitor's newspaper); *Donrey*, 809 F.2d 534 (court sustained the taxpayer's depreciation deductions for a list of terminable-at-will subscribers acquired in the purchase of an ongoing newspaper business); *Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) 771 (discussed *supra* note 61).

63. *See, e.g.*, Southern Bancorp., Inc. v. Commissioner, 847 F.2d 131 (4th Cir. 1988); AmSouth Bancorp. and Subsidiaries v. United States, 681 F.Supp. 698 (N.D. Ala. 1988). In both cases, the taxpayer failed to meet its burden of proof that the acquired deposit base had a value separate and distinct from goodwill. *See also Golden State Towel and Linen Serv.*, 373 F.2d 938; *Metropolitan Laundry*, 100 F.Supp. 803; *Newark Morning Ledger*, 945 F.2d 555. In *Newark*, the Court of Appeals concluded: "In any case, consistent with the prevailing case law, we believe that the Service is correct in asserting that, for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." 945 F.2d at 568.

64. New York State Bar Association Tax Section, *Report on Proposed Legislation on Amortization of Intangibles (H.R. 3035)*, 53 TAX NOTES 943, 946 (1991). *See also Newark Morning Ledger*, 113 S. Ct. at 1678 ("The courts that have found these assets depreciable have based their conclusions on carefully developed factual records.").

65. New York State Bar Association Tax Section, *supra* note 64, at 946.

66. *See infra* notes 77-79 and accompanying text.

67. Treas. Reg. § 1.167(a)-3 (as amended in 1986).

residual remaining after the purchase price of a business is allocated to all tangible and separately identifiable intangible assets based on their relative fair market values.[68] The regulations, though, do not define goodwill.[69]

Despite the lack of a definition in the regulations, three separate conceptual approaches have been utilized to define goodwill: (1) customer structure, (2) going concern value and (3) extraordinary earning power.[70] In terms of customer structure, goodwill has been repeatedly defined in the courts as "the expectancy that old customers will resort to the old place,"[71] and "the expectancy of continued patronage for whatever reason."[72]

Going concern value, which results from the use of assets in an ongoing business, is similar to, but is also different from, goodwill. Goodwill is related to above average profitability. Going concern value, however, can exist in a business with only average profitability because this concept is based on the premise that an ongoing business with average profits is more valuable than the sum of the fair market values of the individual assets, if separated from the business.[73] Going concern value is rarely valued separately. Indeed, going concern value is usually treated as an integral part of goodwill.[74]

In contrast to customer structure and going concern value, which

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68. *See* Temp. Treas. Reg. § 1.1060-1T(d)(2)(iii) (1988), which states that the residual is composed of "intangible assets in the nature of goodwill and going concern value."

69. Treas. Reg. § 1.167(a)-3 (as amended in 1986).

70. Donaldson, *supra* note 36, at 294-95.

71. Newark Morning Ledger Co. v. United States, 945 F.2d 555, 559 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993) (quoting Commissioner v. Killian, 314 F.2d 852, 855 (5th Cir. 1963)).

72. *Id.* at 559 (quoting Boe v. Commissioner, 307 F.2d 339, 343 (9th Cir. 1962)).

73. WELSCH ET AL., *supra* note 34, at 520 n.4.

74. *Id. But see* Concord Control, Inc. v. Commissioner, 35 T.C.M. (CCH) 1345, 1356 (1976), *aff'd*, 615 F.2d 1153 (6th Cir. 1980). The court required the taxpayer to allocate a portion of the purchase price of a business to nondepreciable going concern value because it found that the taxpayer acquired "an ongoing business that was earning money, had a trained staff of employees, had a product line presently ready for sale and equipment ready for immediate use." Although the court found that the acquired business had excess earning capacity, it found that the business did not possess goodwill. The court stated that excess earning capacity was not enough in and of itself to demonstrate the existence of goodwill. The expectancy of continued patronage or continuing competitive advantage is also a necessary requirement. The court found this latter element of goodwill lacking because the company was engaged in an industry with a great degree of competition and little customer loyalty and it manufactured a product line that was "virtually identical to those of its competitors." Although the Sixth Circuit affirmed the basic holding below, the case was remanded to the Tax Court for an explanation of the method used to calculate going concern value. *See* Concord Control, Inc. v. Commissioner 78 T.C. 742 (1982).

are mere conceptual notions, in practice, goodwill has often been quantitatively measured by excess earning power.[75] Under this method, the parties negotiating the sale of a business determine a value for goodwill by capitalizing the projected earnings of a business in excess of a normal rate of return on the tangible and specifically identifiable intangible assets of the business. With this approach, the value of goodwill diminishes over time because excess earnings are projected over a finite period and cannot reasonably be expected to continue indefinitely.[76]

Despite the limited expected life of goodwill under the capitalization of excess earnings approach, the courts have consistently found that goodwill is nondepreciable as a matter of law under the theory that goodwill does not have a limited life and, therefore, does not decline in value over time.[77] One court stated, "goodwill in any practical sense, has no terminable life; but rather continues in existence just so long as the business continues . . . ."[78] If goodwill retains its value indefinitely, it should be nondepreciable because the purpose of depreciation is to measure the decline in value of an asset over time[79]

The theory that goodwill has an unlimited life, although well established in the courts, has not gone unquestioned. As one commentator points out, the goodwill of a business that exists at a given

75. Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 HARV. L. REV., 859, 860-61 (1968). One theory suggests that the capitalization of excess earnings method is conceptually sound because it allows the use of a higher rate of return to discount the excess earnings stream than the rate used to discount normal earnings. The higher rate is used to account for the greater risk of not earning above the normal rate of return. *See* WELSCH ET AL., *supra* note 34, at 521-22. *See also supra* note 34 for an example of the calculation of goodwill under the capitalization of earnings approach.

76. Walter C. Frank, *Goodwill is not Immortal: A Proposal to Deduct the Exhaustion of Purchased Goodwill*, 23 J. TAX'N 380, 381 (1965). The author recommends writing off goodwill over the period of projected excess earnings. For example, if the value of goodwill was established by the purchase of excess earnings over five years, the author recommends depreciating goodwill over that five year period. *Id.*

77. *See, e.g.*, Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1247 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) ("Some intangible capital assets are, of course, non-amortizable as a matter of law, with the most frequently litigated example being the 'goodwill' of an ongoing business.").

The court held, however, that other intangibles related to goodwill (e.g., newspaper subscriber lists) are not nondepreciable as a matter of law. The taxpayer has the burden of proving that the asset has "an ascertainable value separate and distinct from goodwill" and a limited useful life that can be estimated with reasonable accuracy. *Id.* at 1250. *See also* Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670 (1993) (discussed *supra* notes 61-62 and accompanying text).

78. Dodge Bros., Inc. v. United States, 118 F.2d 95, 100 (4th Cir. 1941). The taxpayer attempted to depreciate the value allocated to its rights to the design of a specific model of car acquired in the purchase of the Dodge Brothers business. The Court denied depreciation on the ground that the design of the car was inseparable from purchased goodwill. *Id.* at 100-02.

79. *See* CHIRELSTEIN, *supra* note 19, ¶ 6.08, at 142.

point in time results much more from the recent activities of the business than from a continuation of goodwill that was in existence at some time in the company's history. Therefore, without continual efforts to create new goodwill, a business will soon find that whatever goodwill (i.e., the ability to generate excess earnings) it once had has disappeared.[80]

Although excess earnings can be projected to continue for a certain number of years, the conditions which give rise to the excess earnings cannot be assumed to be permanent.[81] A change in management, improvements in competitors' products, and changes in technology are just a few examples of the unlimited number of internal and external factors that can cause the erosion of the potential for excess earnings.[82] This erosion results in the decline in value of the taxpayer's purchased goodwill, which should be the basis for a depreciation deduction.

C. *Purchased Intangibles Versus Internally Developed Intangibles*

In general, a business generating excess earnings has obtained goodwill by one or both of two methods: creation of goodwill internally or acquisition of goodwill in the purchase of an ongoing business. Most expenditures that a business incurs in creating goodwill internally are deductible immediately. Examples include training employees and advertising (deductible as ordinary and necessary business expenses under section 162) and research and development costs (section 174).[83] These goodwill-creating expenditures are deductible in the year incurred even though their purpose is to contribute to the production of revenue in future years, as well as the current year.

80. Frank, *supra* note 76, at 381.
81. Frank, *supra* note 76, at 380.
82. *Id.*
83. Gregorcich, *supra* note 28, at 256. Note that I.R.C. § 174 (1988) was enacted to eliminate uncertainty and to encourage taxpayers to engage in research and experimentation. BITTKER, *supra* note 16, ¶ 26.3.1, at 26-22. Section 174 allows taxpayers to elect either current deduction of research and experimental expenditures or capitalization and amortization over not less than 60 months. Before § 174, uncertainty existed concerning whether research and experimental expenditures were entitled to current deduction or required to be capitalized because they provided long-term benefits. Additionally, when capitalization was required, amortization was allowed only if a limited useful life could be shown for the benefits derived. BITTKER, *supra* note 16, ¶ 26.3.1, at 26-22 to 26-23.

In contrast, the purchaser of an ongoing business is denied depreciation deductions for acquired goodwill. As a result of this inconsistency, two similarly situated taxpayers are treated differently by the law.[84] The developer of goodwill is allowed to immediately deduct goodwill-creating expenditures while also deferring to future years the recognition of revenue generated by these expenditures. The purchaser of an ongoing, profitable business, however, normally will expect revenue to be generated by the purchased goodwill immediately after purchase. As a consequence, in addition to being denied depreciation deductions for purchased goodwill, in many cases the purchaser must recognize revenue for tax purposes sooner than the developer of goodwill, whose expenditures may not yield significant revenues for several years. This is particularly true in the case of a new company that is not yet well-established.[85] This discrimination in favor of the developer is partially alleviated by allowing the purchaser current deductions for expenditures, such as advertising and research and development, that are intended to replace eroding purchased goodwill.[86]

V. ADDITIONAL JUSTIFICATIONS FOR DEPRECIATION OF GOODWILL AND OTHER INTANGIBLES IN THE NATURE OF GOODWILL

This section of the Comment proposes additional arguments in favor of allowing tax depreciation of goodwill by comparison to the financial accounting treatment of goodwill, as well as by comparison

84. The similar situations of these two types of taxpayers can be illustrated by a hypothetical comparison. Assume the following facts:

1. Both *A* and *B* own identical businesses possessing goodwill with a value of $5,000,000.
2. *A*'s goodwill was created by spending $1,000,000 in each of the first five years of the company's existence on goodwill-creating expenditures (e.g., advertising, research and development, and training a labor force).
3. *B* purchased an ongoing business and allocated $5,000,000 of the purchase price to goodwill according to § 1060.

The situations of *A* and *B* are very similar. Both *A* and *B* possess $5,000,000 of goodwill in identical businesses. *A*, however, created goodwill with $5,000,000 of tax-deductible expenditures while *B* purchased goodwill with a $5,000,000 nondeductible expenditure. Although both taxpayers theoretically possess the same excess earning power, the cost to *A* of creating goodwill is substantially less than *B*'s cost to purchase it because of the different tax treatment of the two taxpayers.

One notable difference between *A* and *B* is that *A*'s annual expenditures of $1,000,000 are of a recurring nature, which is normally associated with immediate deductibility. In contrast, *B*'s expenditure is a lump-sum payment for long-term future benefits, which is a typical characteristic of a capital expenditure. Therefore, requiring *B* to capitalize the $5,000,000 paid for goodwill is proper. This difference, though, does not justify the inequity between *A* and *B* that results from the denial of depreciation of purchased goodwill.

85. Comment, *Depreciability of Going Concern Value*, 122 U. PA. L. REV. 484, 493 (1973).

86. *Id.* at 493-94.

to the amortization of start-up and organizational expenditures under sections 195 and 248, respectively. First, however, an examination will be made of the effect of nondepreciability on the availability and timing of deductions for goodwill and, in turn, the effect on the purchaser's cash flow.

A. Effect of Nondepreciability of Goodwill on the Availability and Timing of Deductions and the Buyer's Cash Flow

Because goodwill cannot be depreciated for tax purposes, the purchaser of an ongoing business is not allowed any deductions for the erosion of purchased goodwill while operating his business. Although goodwill is not depreciable, the taxpayer may still obtain a deduction when he sells the business because goodwill retains its original basis.[87] This basis is then subtracted from the selling price allocated to goodwill, thereby reducing the capital gain or increasing the capital loss to the taxpayer.[88] If the taxpayer never sells the business, however, he will never recover the cost of the purchased goodwill.[89]

A taxpayer buying a profitable business will always prefer annual depreciation deductions over a deductible loss or reduction in taxable gain on the sale of the business. This is so because depreciation deductions enable the taxpayer to reduce his tax bill each year as he operates the acquired business. In contrast, a deductible loss or a reduction in taxable gain is only beneficial when the business is sold, which may not occur until several years in the future. A taxpayer receives a greater benefit from current year deductions than future deductions because he can either invest the funds made available by the reduced tax bill or use them to meet immediate cash needs. For example, if a hypothetical taxpayer can reduce his tax bill by $100,000 each year by recovering his investment in purchased goodwill through depreciation over an assumed twenty year useful life ($2,000,000 in deductions over 20 years), he would be in a much better position than under current law which requires him to wait until the business is sold before recovering his investment. This is

87. "Basis" is the term used in the Code to refer, generally, to the cost of property. I.R.C. § 1012 (1988). Under I.R.C. § 1016(a)(2) (1988), a taxpayer's basis in property is reduced as depreciation deductions are taken.

88. *See* I.R.C. § 1001 (1988) for the rules governing the calculation of gain or loss on the disposition of property.

89. As explained *supra* note 40, "cost recovery" is a term often used to refer to tax depreciation. Cost recovery also refers to the return of a taxpayer's investment in an asset through depreciation deductions or a deductible loss or reduction in taxable gain on the final disposition of the asset. *See* CHIRELSTEIN, *supra* note 19, ¶ 6.08, at 137.

true even though the taxpayer may realize a tax benefit of $2,000,000 on the sale of the business.[90]

Because of the effects on the purchaser's cash flow, the amount of the purchase price of a business recoverable through depreciation deductions may be a significant factor in determining the financial success of a purchased business.[91] The effects are more pronounced for a company such as a service business which relies primarily on intangible, rather than tangible, assets in producing its income. The denial of depreciation deductions to the purchaser of such a business severely restricts the purchaser's after-tax cash flow.[92]

B. *Comparison to Financial Accounting Treatment*

Under Generally Accepted Accounting Principles (GAAP),[93] the cost of purchased intangibles in the nature of goodwill is required to be amortized, using the straight line method, through charges against income over the period of years estimated to be benefitted, not to exceed forty years.[94] Accounting Principles Board Opinion Number 17 ("APB 17") lists several factors that a company must consider in estimating the useful life of various intangible assets:

a. Legal, regulatory or contractual provisions may limit the maximum useful life.
b. Provisions for renewal or extension may change a specified limit on useful life.

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90. If our hypothetical taxpayer can invest the $100,000 made available annually by depreciation deductions at an assumed 8% annual return, he will receive tax benefits over a 20-year period with a present value of $981,815. If the taxpayer cannot depreciate goodwill, however, and sells the business in 20 years, he will only receive a tax benefit from his $2,000,000 basis in goodwill with a present value $429,096.

The denial of depreciation deductions in this example results in a penalty to the taxpayer of $552,719. Of course, this example assumes that the taxpayer is subject to one constant tax rate throughout the 20 year period. While this assumption is extremely simplified, this example illustrates the detrimental effects of the nondepreciability of goodwill.

91. Gregorcich, *supra* note 28, at 257.

92. *Id.*

93. The term, "Generally Accepted Accounting Principles," refers to the authoritative pronouncements of the accounting profession that determine the standards to be used by companies in recording the economic effects of business transactions and in reporting these effects to outside parties, such as bankers and investors. This process is referred to as "financial accounting." Currently, accounting standards are promulgated by the Financial Accounting Standards Board. *See* WELSCH ET AL., *supra* note 34, at 3-8.

94. INTANGIBLE ASSETS, Accounting Principles Board Opinion No. 17, ¶¶ 27, 29, 30 (Accounting Principles Bd. 1970), *reprinted in* Original Pronouncements Vol. II, Accounting Standards as of June 1, 1992, 227-28 [hereinafter APB 17]. Paragraph 27 of APB 17 states that "the Board believes that the value of intangible assets at any one date eventually disappears and that the . . . costs of intangible assets should be amortized . . . over the periods estimated to be benefitted." APB 17, ¶ 27.

The Accounting Principles Board was the body responsible for promulgating accounting standards until the creation of the Financial Accounting Standards Board in 1973.

c. Effects of obsolescence, demand, competition, and other economic factors may reduce a useful life.
d. A useful life may parallel the service life expectancies of individuals or groups of employees.
e. Expected actions of competitors and others may restrict present competitive advantages.
f. An apparently unlimited useful life may, in fact, be indefinite and benefits cannot be reasonably projected.
g. An intangible asset may be a composite of many individual factors with varying effective lives.[95]

The required amortization of purchased goodwill for financial accounting purposes is based on the principle that the net income of a company is overstated unless all costs are deducted from related revenues.[96] Under this concept, goodwill is considered similar to most other assets of a business. The costs in obtaining goodwill, therefore, should be amortized in future years under a method that produces a fair pattern of charges against income.[97] The negotiations leading to the purchase price of the acquired business may indicate the most appropriate time period for amortization. Because the purchaser of a business acquires goodwill with the expectation that the company will generate excess earnings, in theory its cost should be amortized over the anticipated future period of excess earnings.[98] Additionally, because many factors (seven of which are described in the preceding paragraph) may cause the deterioration of purchased goodwill over time, proving its continued existence at a future date is difficult.[99]

The determination of net income for tax purposes corresponds closely to the process of determining net income for financial accounting purposes.[100] In fact, the regulations indicate that GAAP

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95. *Id.* ¶ 27.

96. GEORGE R. CATLETT & NORMAN O. OLSON, ACCOUNTING FOR GOODWILL 80, Accounting Research Study No. 10 (Am. Inst. of Certified Pub. Accountants 1968).

97. *Id.* This view is similar to the financial accounting concepts underlying depreciation of tangible assets. Accounting Terminology Bulletin No. 1 ¶ 56, *reprinted in* WELSCH ET AL., *supra* note 34, at 481, defines depreciation as follows:

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any), over the estimated useful life of the unit . . . in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year.

98. CATLETT & OLSON, *supra* note 96, at 80. *See* discussion of excess earnings as a basis for determining goodwill, *supra* notes 34, 75-76 and accompanying text.

99. CATLETT & OLSON, *supra* note 96, at 80. Under this view, any goodwill that continues to exist must be new goodwill that is created since the acquisition of the business. *See supra* text accompanying note 80 for additional discussion of this concept.

100. Harold Dubroff et al., *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 ALB. L. REV. 354, 374

"will ordinarily be regarded as clearly reflecting income" for tax purposes.[101] Moreover, the courts generally give favorable treatment to the Service's reliance on GAAP as an accounting method that clearly reflects income.[102] The courts have held, however, that some practices followed under GAAP are not acceptable for tax accounting purposes.[103]

Despite the lack of complete conformity to financial accounting, the Regulations and judicial interpretations make clear that tax accounting is significantly influenced by GAAP. The rationale underlying amortization of goodwill for financial accounting purposes (i.e., changes in the business environment leading to the deterioration of the capacity to generate the excess earnings embodied in purchased goodwill) should be recognized by the tax law.

C. *Comparison to Sections 195 and 248*

The amortization of start-up and organizational expenditures under sections 195 and 248, respectively, provides further justification for allowing depreciation of intangibles.[104] Amortization of

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(1983).

101. Treas. Reg. § 1.446-1(a)(2) (as amended in 1987). The regulation states as follows:

> A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

102. Dubroff et al., *supra* note 100, at 391. *See also*, All-Steel Equip., Inc. v. Commissioner, 467 F.2d 1184 (7th Cir. 1972); Photo-Sonics, Inc. v. Commissioner, 357 F.2d 656 (9th Cir. 1966). In both cases, the taxpayer's method of valuing inventory was rejected by the court because the method was not an acceptable accounting practice for GAAP purposes and did not clearly reflect income for income tax purposes.

103. *See e.g.*, Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 540, 542 (1979). The taxpayer's write-down of excess inventory to its scrap value, while in accordance with GAAP, was disallowed as a tax deduction because the merchandise was neither defective nor offered for sale at its reduced value. The Court stated that the Regulations "embody no presumption" that any accounting practice that conforms to GAAP is valid for income tax purposes. The Court also stated, though, that in most cases GAAP accounting practices are acceptable for tax purposes.

In *Thor*, the Court discussed the different goals of tax and financial accounting (GAAP), i.e., GAAP is based on the concept of conservatism, which seeks to avoid overstatement of net income in reporting to financial statement users, while the primary objectives of the income tax system are the equitable collection of revenue and the protection of the public fisc. *Id.* at 542-43.

See also Schlude v. Commissioner, 372 U.S. 128 (1963). An accrual method taxpayer was required to report amounts received in advance for dance lessons as gross income for tax purposes in the year of receipt even though the taxpayer recognized income for GAAP purposes as it was earned over the period of time during which the lessons were to be given.

104. I.R.C. § 195(c)(1) (1988) defines a start-up expenditure as any amount-

> (A) paid or incurred in connection with-
> (i) investigating the creation or acquisition of an active trade or business, or
> (ii) creating an active trade or business, . . . and

start-up expenditures is allowed over a relatively short period (five years) despite the creation of goodwill that will benefit the business for an undetermined number of years. Because the five year amortization period is mandated by statute, the taxpayer is not required to prove a limited useful life for the benefits provided by start-up expenditures. In the case of purchased goodwill, however, the inability of the taxpayer to reasonably estimate a useful life is the primary obstacle to securing depreciation deductions.[105]

The legislative history of section 195, as enacted in the Miscellaneous Revenue Act of 1980, explained that investigatory costs eligible for amortization include expenses such as analysis or survey of potential markets, products, labor supply, and transportation facilities.[106] Eligible start-up expenditures also include costs which are incurred after a decision has been made to establish a business, but before the business actually begins.[107] Examples of such start-up costs include advertising, salaries and wages of employees while being trained, travel expenses associated with lining up distributors, suppliers and customers, and executive salaries.[108]

In general, capitalization has been required of start-up expenditures incurred prior to beginning a new business.[109] The capitalization requirement is also present under section 195.[110] Before section

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(B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

I.R.C. § 248(b) (1988) defines an organizational expenditure as any expenditure which-

(1) is incident to the creation of the corporation;
(2) is chargeable to capital account; and
(3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

Provided the taxpayer makes the proper election, both start-up and organizational expenditures are amortizable over a five-year period beginning with the month in which the taxpayer begins business.

105. *See supra* notes 77-78 and accompanying text.

106. H.R. REP. No. 1278, 96th Cong., 2d Sess. 10 (1980); S. REP. No. 1036, 96th Cong., 2d Sess. 11 (1980). *See supra* text accompanying notes 31 and 83 for examples of similar expenditures (i.e., research and development and establishing a marketing structure) that are deductible in creating goodwill for an ongoing business. While such expenses must be capitalized and amortized if incurred during the start-up phase of a business, they are deductible currently if incurred by an ongoing enterprise in pursuit of its existing business.

107. H.R. REP. No. 1278 at 10-11; S. REP. No. 1036 at 11-12.

108. *Id.*

109. GRAETZ, *supra* note 21, at 361.

110. I.R.C. § 195(a) (1988). Section 195(a) states, "Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures."

195 was enacted, however, amortization of capitalized start-up costs was ordinarily disallowed.[111] By allowing amortization over a five-year period, however, Congress sought to decrease the controversy and litigation in this area of the tax law.[112]

A primary theory underlying the capitalization requirement is that start-up expenditures create an asset or produce a significant benefit that extends beyond the current taxable year.[113] Similarly, when a taxpayer purchases an ongoing business he acquires assets (both tangible and intangible) that will benefit the business in future years. Start-up expenditures, such as advertising, training of employees, and lining up customers, suppliers, and distributors may also create intangible assets, including goodwill, that become part of the ongoing enterprise once business begins.[114]

Another Congressional objective in enacting section 195 was to facilitate economic growth by encouraging formation of new businesses through the recovery of previously nonamortizable start-up expenditures.[115] Although disallowing depreciation of purchased intangibles in the nature of goodwill does not discourage the formation of new businesses, it does restrict, to a certain degree, the free transfer of assets by reducing the price a seller is able to obtain on the sale of his business.

When the parties negotiate the purchase and sale of a business, an allocation of the purchase price is typically made in the purchase agreement to the specific assets purchased based upon each asset's fair market value.[116] Because the buyer and seller have conflicting tax interests, the purchaser will want a reduction in the purchase

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111. BITTKER, *supra* note 16, ¶ 20.4.4. *See also* Richmond Television Corp. v. United States, 354 F.2d 410 (4th Cir. 1965). The taxpayer was denied amortization of job training expenses incurred before obtaining its operating license from the Federal Communications Commission and before commencement of broadcasting because renewal of the license was almost certain and thus the start-up costs would benefit the taxpayer for an indefinite period of time.

112. H.R. REP. NO. 1278 at 10; S. REP. NO. 1036 at 11. The controversies and litigation involving start-up expenditures occurred when taxpayers were denied current deductions or amortization. *See, e.g.*, Central Texas Sav. & Loan Ass'n v. United States, 731 F.2d 1181 (5th Cir. 1984) (taxpayer denied deductions for expenditures in investigating and starting up new branches on the grounds that a "separate and distinct asset" was created). *See also Richmond Television*, 354 F.2d 410 (taxpayer denied amortization of start-up expenses).

113. GEORGE B. JAVARAS ET AL., START-UP EXPENSES ¶ 105.02 (CCH Tax Transactions Library 1992).

114. *See supra* text accompanying note 31 for examples of similar expenditures that create goodwill in an ongoing business.

115. H.R. REP. NO. 1278 at 10; S. REP. NO. 1036 at 11.

116. Harold E. Abrams & Gregory K. Cinnamon, *Purchase Price Allocations Restricted by Tax Reform Act of 1986*, 15 TAX'N FOR LAW. 210, 210 (1987).

price if any part of the price is allocated to nondepreciable intangibles such as goodwill or going concern value.[117] Under the current tax rate structure, however, the buyer versus seller conflict has been diminished. Of course, if future tax law changes increase the capital gains preference by a reduction in the capital gains rate or an increase in the rates on ordinary income, the conflicting tax interests of buyer and seller will again become a significant factor in negotiating the purchase and sale of a business. Under a tax law with a larger capital gains preference, if goodwill were depreciable, the buyer would be less reluctant to allocate a reasonable portion of the purchase price to goodwill and the seller would be able to negotiate a price for his business free of the artificial restrictions imposed by the current rule of nondepreciability.

In addition to the amortization of start-up expenditures under section 195, the Code also permits the amortization of another type capital expenditure having an indeterminate life. Section 248 allows five-year amortization of the organizational expenditures incurred in the creation of a corporation.[118] Amortization of organizational expenditures is allowed despite the benefits provided to a corporation

117. *See* Gregorcich, supra note 28, at 257-58; CHIRELSTEIN, *supra* note 19, ¶ 17.04, at 327. A buyer prefers allocation of the purchase price to assets that will give rise to current or future tax deductions (e.g., depreciable tangible assets, the seller's covenant not to compete, which may be depreciable over the life of the agreement, or inventory, which gives rise to a deduction when sold to customers). The buyer would prefer a zero allocation to goodwill, if possible (although this is not likely in the sale of a going business), because an allocation to goodwill will render that portion of the investment nonrecoverable until the business is sold or terminated. The seller, on the other hand, prefers allocation of as much of the purchase price as possible to goodwill, with as little as possible going to inventory, depreciable tangible assets, covenant not to compete, and other ordinary income items. The seller desires this type of allocation because he receives capital gain treatment on the sale of goodwill, while he is taxed at ordinary income rates on the sale of most other assets.

The 1986 Tax Reform Act substantially reduced the buyer versus seller conflict by reducing the capital gains preference. Currently, individuals are taxed at a top marginal rate of 31% on ordinary income (the top marginal rate for individuals will be increased to 39.6% now that H.R. 2264 has been enacted), while the maximum capital gains rate is 28%. Before the 1986 Act, the highest individual marginal rate was 50% while the maximum capital gains rate was 20%. *See* discussion in James P. Kleier, *Avoiding "Excess Purchase Price by Careful Allocation to Intangibles* 16 TAX'N FOR LAW. 186, 186 (1987).

Note that the latitude of buyers and sellers in allocating the purchase price has been significantly restricted by § 1060, which requires that the allocation now be made in a manner similar to that prescribed by I.R.C. § 338(b)(5) (1988). In other words, the Service is now less likely to accept the parties' allocation at face value, even if the parties have conflicting tax interests. *See* Abrams & Cinnamon, *supra* note 116, at 210.

118. *See supra* note 104 for the Code's definition of organizational expenditures.

throughout its entire life, which is unlimited in most instances.[119]

VI. Possible Solutions to the Nondepreciability Problem

As examined in previous sections of this Comment, the obstacle preventing depreciability of goodwill has been the belief, as embodied in the Treasury Regulations and court decisions, that goodwill has an unlimited, or at least indeterminate, life.[120] This section of the Comment concerns analyzing possible solutions to the controversies created by requiring taxpayers to estimate a useful life for goodwill-related intangibles and prove sufficient separateness from goodwill itself in order to sustain depreciation deductions.

A. Statutory Life

Under this method, a fixed useful life would be established by statute for goodwill and other related intangibles.[121] Statutory lives are employed in many other areas of the Code, such as cost recovery of tangible property under section 168 and the amortization of start-up expenditures and organizational expenditures under sections 195 and 248, respectively.[122]

The five-year amortization of start-up expenditures under section 195 was a compromise between immediate deduction or capitalization without amortization.[123] One of the objectives behind this compromise was simplification of the tax law through decreased

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119. West's Federal Taxation: Corporations, Partnerships, Estates and Trusts, 1981 Annual Edition 82 (1980).

120. See *supra* notes 46-49 and 77-79 and accompanying text.

121. *See, e.g.*, the intangibles provision of H.R. 13, 103d Cong., 1st Sess. (1993), which was passed by the House as part of H.R. 2264, 103d Cong., 1st Sess. (1993) (*see* discussion *supra* note 1). The H.R. 13 intangibles provision proposes that a taxpayer would be entitled to depreciate purchased intangibles over a statutory life of fourteen years. The following is a partial list of the intangibles that would be eligible for depreciation under proposed § 197(d): goodwill, going concern value, work force in place, patents, copyrights, customer-based intangibles (including deposit-based and similar items acquired in the purchase of a financial institution), supplier-based intangibles, licenses, covenants not to compete, and franchises. Proposed § 197(b) prescribes that, except for depreciation over the statutory life, no depreciation deduction would be allowed for the intangibles listed in § 197(d). Apparently, this restriction is intended to eliminate the problems of proof and controversy that would arise if a taxpayer attempts to depreciate an intangible (e.g., a customer list or noncompete covenant) over a lesser number of years than the statutory life. Proposed § 197(c) excludes self-created intangibles from the definition of depreciable intangibles. Therefore, expenditures incurred to create intangibles will maintain their deductible status (e.g., advertising and research and development) under the proposed law.

122. *See supra* notes 20-21, 40-41 and 104-19 and accompanying text.

123. John W. Lee, *Start-Up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform, and a Touch of Basics*, 6 Va. Tax Rev. 1, 7 n.15 (1986). The author states that this compromise was based on a similar compromise concerning amortization of organizational expenditures under § 248.

controversy and litigation.[124] Similarly, simplification is needed in the area of amortization of intangibles. A statutory life should significantly reduce the controversy and litigation that arises under the current law when a taxpayer attempts to depreciate a customer list or similar intangible that is closely related to goodwill.[125] Before the Supreme Court's decision in *Newark Morning Ledger*, depreciation of these types of intangibles was often denied by the Service and the courts on the grounds that they were inseparable from nondepreciable goodwill.[126] The *Newark* decision could lead to an increasing number of controversies between taxpayers and the Service. Courts will no longer be able to routinely deny depreciation because *Newark* held that customer-based intangibles are not nondepreciable as a matter of law.[127] Thus, taxpayers will now be more inclined to develop sophisticated factual proof to support their depreciation deductions.[128]

In this era of mammoth federal budget deficits, changes to the tax law must not reduce revenues. In drafting the intangibles provision that was included in H.R. 13, Congress selected a fourteen year statutory life so that the bill would be approximately revenue neutral over the following five fiscal years.[129] The revenue loss from depreciation of currently nondepreciable intangibles was anticipated to be

124. *See supra* note 112 and accompanying text.

125. The intangibles provision of H.R. 13, if enacted under H.R. 2264, should accomplish this objective because it mandates a statutory life for the types of intangibles that have created controversy under the existing tax law, such as customer-based intangibles, covenants not to compete, and consulting agreements. *See also supra* notes 12 and 121 and accompanying text.

126. *See, e.g.*, Newark Morning Ledger Co. v. United States, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993) (discussed *supra* notes 46-47 and 61-62 and accompanying text); Dodge Bros., Inc. v. United States, 118 F.2d 95 (4th Cir. 1941) (discussed *supra* note 78).

Note that the question of depreciation of goodwill itself is almost never litigated because it has long been settled that goodwill is nondepreciable as a matter of law. *See, e.g.*, Houston Chronicle Pub. Co. v. United States, 481 F.2d 1240, 1247 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) ("[T]his proposition is so well settled that the only question litigated in recent years regarding this area of the law is whether a particular asset is 'goodwill.'"); *See also* Treas. Reg. § 1.167(a)-3 (as amended in 1986) ("No deduction for depreciation is allowable with respect to goodwill.").

127. *See* related discussions *supra* notes 60-63 and accompanying text.

128. *See* related discussion *supra* notes 64-65 and accompanying text.

129. H.R. REP. No. 631, 102d Cong., 2d Sess. 210 (1992); S. REP. No. 300, 102d Cong., 2d Sess. 23 (1992). Congress recognized that the actual useful lives of certain intangibles depreciable under current law may be shorter than 14 years, while the useful lives of other intangibles may be longer than 14 years or indeterminate. *Id. See also* JOINT COMMITTEE ON TAXATION, 102d Cong., 2d Sess., ESTIMATED BUDGET EFFECTS OF CONFERENCE AGREEMENT TO H.R. 11 6 (Serial No. JCX-38-92) (Oct. 6, 1992).

Before the Supreme Court's decision in *Newark Morning Ledger*, concern existed offset by the application of the bill to currently depreciable intangibles with lives that are typically shorter than fourteen years.[130]

A statutory life system would be an effective method of solving the problems of inequity, controversy, and complexity in the current tax treatment of intangible assets.[131] However, such a system can be criticized on the ground that it does not recognize that different businesses face different levels of risk and that different elements may be involved in creating goodwill.[132] Despite this criticism, a statutory life for intangibles is desirable because of its expected simplicity and effectiveness.

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about the effect the decision would have on the revenue estimates for H.R. 11 or any subsequent bill such as H.R. 13. The 14-year life proposed by H.R. 11, which was carried over into H.R. 13, was designed to be revenue-neutral as compared to the then-existing (i.e., before the Supreme Court's decision in *Newark*) law governing depreciation of customer-based intangibles. Before the *Newark* decision, one commentator hypothesized that if the Supreme Court were to reverse the Third Circuit, the Service would likely lose or concede more cases. Because the *Newark* Court held for the taxpayer, the 14-year statutory life should actually result in increased tax revenues if the revenue projections for the intangibles provision of H.R. 11 prove to be reasonably accurate. *See* Reuven S. Avi-Yonah, *Newark Morning Ledger: A Threat to the Amortizability of Acquired Intangibles*, 55 TAX NOTES 981, 985 (1992).

130. H.R. REP. No. 631 at 210; S. REP. No. 300 at 23. *See, e.g.*, Colorado Nat'l Bankshares, Inc. v. Commissioner, 60 T.C.M. (CCH) 771 (1990), *aff'd*, 984 F.2d 383 (10th Cir. 1993) (discussed *supra* note 61). The court sustained the taxpayer's depreciation deductions over periods ranging from 3 to 10 years of the core deposits intangible acquired in the purchase of several banks. Under H.R. 13, core deposits intangible (referred to as deposit base in proposed § 197, see *supra* note 121) would be depreciated over 14 years. Covenants not to compete, another significant currently depreciable intangible which would be depreciable over 14 years under the intangibles provision of H.R. 13, typically are depreciated over lives of five years or less under current law.

131. The question of retroactivity becomes a concern when analyzing Congress' stated objective to reduce controversy and litigation. Retroactivity would be desirable from the standpoint of settling present and future controversies involving intangibles purchased before the effective date of the bill. New York State Bar Association Tax Section, *supra* note 64, at 960. The intangibles provision of H.R. 13, however, would apply only to intangibles acquired after the date of enactment, unless the taxpayer made an election to have the new law apply to property acquired after July 25, 1991.

The nonretroactivity of H.R. 13 is the better approach. Current law is well-settled on certain issues. For example, goodwill is not depreciable as a matter of law, but covenants not to compete generally are depreciable. Therefore, retroactivity would frustrate the legitimate expectations of some taxpayers and give other taxpayers windfalls that were neither bargained for nor expected. *Id.* Retroactivity was included in the intangibles provision of H.R. 4210, the tax bill that was vetoed in March 1992. The provision, however, was deleted when H.R. 11 was drafted in June 1992.

132. Note, *supra* note 75, at 873. The different elements involved in creating goodwill in different businesses can be illustrated by comparing a service business that has a minimal investment in plant and equipment and that will likely generate most of its goodwill through the skills of the owner, management, or labor force to a manufacturer that has a heavy investment in plant and capital equipment and generates a large portion of its goodwill through the organization of buildings and equipment into an efficiently run plant. *See* Gregorcich, *supra* note 28, at 256-57.

B. *Immediate Deduction of Purchased Goodwill*

This method would allow immediate deduction of goodwill and other intangibles in the nature of goodwill in the year of purchase. In addition to having the virtue of simplicity, this method would eliminate the different treatment of purchased goodwill versus internally developed goodwill.[133] Immediate deduction, however, is objectionable on two grounds. First, such a deduction would result in a serious misstatement of taxable income in cases where the amount of the deduction is significant.[134] Second, such serious misstatements of income would result in significant and unnecessary decreases in government revenue.

C. *Depreciation Over Period of Projected Excess Earnings*

Under this method, the taxpayer would be allowed to depreciate goodwill and other intangibles in the nature of goodwill over the period of years that excess earnings are expected to continue. This method is supportable because parties negotiating the purchase and sale of a business frequently determine its value by discounting projected future earnings to present value.[135] Therefore, deduction of the cost of generating the excess earnings (i.e., the purchase price of goodwill) over the same future period appears reasonable.

This method, however, is deficient because it would allow taxpayers to easily manipulate both the amount of the purchase price allocated to goodwill and other intangibles in the nature of goodwill and the period of projected excess earnings. With the minimal capital

133. *See supra* text accompanying notes 83-86 for a discussion of the inequities that result from this disparate treatment.

134. *See, e.g.*, Newark Morning Ledger Co. v. United States, 945 F.2d 555, 556 (3d Cir. 1991), *rev'd*, 113 S. Ct. 1670 (1993). The taxpayer allocated $94 million of the total tax basis of $328 million in the purchased business to goodwill, going concern value and purchased subscribers. *See also* Colorado Nat'l Bankshares, 60 T.C.M. at 772, 776 (1990). The taxpayer acquired 7 banks for a total adjusted purchase price of $89 million. Of that total, the taxpayer allocated $47 million to two intangible assets - core deposits intangible and goodwill. Core deposits intangible is analogous to the purchased subscribers in *Newark Morning Ledger*.

If immediate deduction were allowed for the purchase of intangibles in the nature of goodwill, the taxpayers in the above cases would have been entitled to deductions of $94 million and $47 million, respectively, in the years in which the businesses were purchased. Given the obvious value of these intangibles in producing future income, immediate deduction would produce a gross distortion of income in the year of purchase, as well future years, in violation of the "clear reflection of income" principle of I.R.C. § 446(b) (1988).

135. *See supra* notes 34 and 75-76 and accompanying text for discussion of the capitalization of earnings approach.

gains preference under current law, the parties do not have a strong incentive to engage in arms-length bargaining regarding the allocation of purchase price to goodwill.[136]

D. Guideline Lives

Guideline lives were introduced as a means of determining depreciable lives for tangible assets in 1962.[137] Under the Guideline Life System, tangible assets were assigned to broad classes with each class having a single Guideline life. For example, the "office furniture and equipment" category had a Guideline Life of ten years and included items such as desks and computers.[138] A single Guideline Life was also given to broad industrial categories, such as assets used in air transport, which, regardless of their nature, were grouped in a single class with a Guideline Life of six years.[139]

A system similar to the Guideline Lives used for tangible assets could be established for intangibles. The Service could develop depreciable lives for intangibles based on the type of asset involved, as well as the kind of industry.[140] For example, depreciable lives could be assigned to subscriber relationships acquired in the newspaper industry and core deposits in the banking industry, as well as the residual acquired goodwill.

Such a system has an advantage over a statutory single life system because it recognizes the different elements of goodwill, as well as the different levels of risk inherent in different industries.[141] If depreciable lives, however, are different for different categories of intangibles, controversy and litigation in this area will continue because taxpayers and the Service would, in many cases, dispute the proper classification of assets.[142] Moreover, determining the proper industry classification for a particular taxpayer would be difficult.[143]

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136. *See supra* note 117 for a discussion of the adversarial tax interests of buyer and seller.

137. Rev. Proc. 62-21, 1962-2 C.B. 418. The Guideline Life system was abolished for assets acquired after 1980 with the enactment of the Accelerated Cost Recovery System under I.R.C. § 168 (1988).

138. GRAETZ, *supra* note 21, at 394-95.

139. *Id.* at 395.

140. New York State Bar Association Tax Section, *supra* note 64, at 949.

141. Note, *supra* note 75, at 873.

142. New York State Bar Association Tax Section, *supra* note 64, at 949.

143. *Id.*

VII. CONCLUSION

Under the current tax law, goodwill is nondepreciable as a matter of law and other intangibles in the nature of goodwill, such as customer lists and customer structure, are frequently found to be nondepreciable by the courts on the grounds that they are inseparable from goodwill and possess indeterminate useful lives. Two significant problems have been created by this law: 1) the unfair treatment of taxpayers who are prevented from recovering their investment in intangible assets through depreciation deductions and 2) the extensive controversy and litigation that has arisen when taxpayers have attempted to depreciate certain intangibles.

The responsibility for developing a solution rests with Congress. To reduce controversy and litigation, and thereby remove a significant burden from the courts and the Service, the legislative solution must result in rules that are fair and relatively easy to administer. Equally important, tax revenues must not be decreased by any change in this area of the law.

The intangibles provision of H.R. 13 satisfies the requirements of administrative ease, fairness, and revenue neutrality. Such a system should bring about a substantial reduction in the number of controversies and their attendant litigation, while also improving the fairness of the tax law.[144]

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144. Controversy may still arise if the Service disputes the taxpayer's allocation of purchase price between tangible assets and intangibles depreciable over the statutory period, which, under H. R. 13 (14 years), is longer than the recovery period of most tangible assets. Incentive for the parties to litigate this type of case, however, is less because the financial stake is smaller as compared to the situation under current law where disputes arise over allocation to depreciable tangible or intangible assets versus nondepreciable intangibles.