REPORT #818

TAX SECTION

New York State Bar Association

REPORT ON ISSUES TO BE ADDRESSED

IN REGULATIONS UNDER SECTION 197

January 13, 1995

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Tax Report #818

TAX SECTION

New York State Bar Association

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January 13, 1995

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: <u>Issues under Section 197</u>

Dear Secretary Samuels and Commissioner Richardson:

Enclosed is a Report by the New York State Bar Association Tax Section commenting on issues arising under section 197 of the Code, relating to 15-year amortization of purchased intangibles.

The Report makes a number of recommendations for regulations to be issued under that section. Among the issues for which regulatory guidance is most urgent are the following:

1. The costs of acquiring contracts not connected to the acquisition of an entire business are excluded from the scope of section 197 only to the extent provided in regulations. These regulations are urgently needed to make the intended statutory exclusion effective.

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Howard O. Colgan, Charles L. Kades, Carter T. Louthan, Samuel Brodsky, Thomas C. Plowden-Wardlaw, Edwin M. Jones, Hon. Hugh R. Jones, Peter Miller, John W. Fager, John E. Morrissey Jr., Charles E. Heming, Richard H. Appert, Ralph O. Winger, Hewitt A. Conway, Martin D. Ginsburg, Peter L. Faber, Hon. Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke, Arthur A. Feder, James M. Peaslee, John A. Corry, Peter C. Canellos

2. Clarification is needed as to when a license of a section 197 intangible is subject to section 197.

3. Guidance is needed concerning the rule disallowing certain losses on the disposition of section 197 intangibles.

4. Guidance is needed concerning the application of the anti-churning rules to a number of common situations.

5. Guidance is needed concerning the proper amortization method when intangibles are purchased for a price that includes contingent payments. We recommend a method that is less back-loaded than that discussed in the legislative history but that we believe fully protects the interests of the government.

Please let us know if we can be of further help in the development of regulations under Section 197.

Very truly yours,

Michael L. Schler
Chair, Tax Section

Tax Report #818

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON COST RECOVERY

REPORT ON ISSUES TO BE ADDRESSED IN REGULATIONS UNDER SECTION 197

January 13, 1995

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON COST RECOVERY

REPORT ON ISSUES TO BE ADDRESSED IN REGULATIONS UNDER SECTION 197

This report[1] comments on regulations to be issued under section 197 of the Internal Revenue Code of 1986 (the "Code"), as added by the Omnibus Budget Reconciliation Act of 1993.[2] Section 197 allows an amortization deduction with respect to the capitalized cost of certain acquired intangible property (a so-called "amortizable section 197 intangible"). The basis of such an intangible is amortized on a straight line basis over a 15-year period beginning in the month during which the intangible is acquired. No other depreciation or amortization deduction is allowed with respect to an amortizable section 197 intangible.

I. Summary of Recommendations.

1. Self-Created Items. Self-created items are included in section 197 only if they are created in connection with the acquisition of a trade or business or a substantial portion thereof. The regulations generally should treat a group of assets as a substantial portion of a trade or business only if the assets are of a type to which goodwill could attach.

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[1] This report was written by Katherine M. Bristor and Stephen B. Land, co-chairs of the Committee on Cost Recovery (the "Committee"), Reuven S. Avi-Yonah, Mark N. Froeba, Cynthia D. Mann and Daniel M. Shefter. Helpful comments were received from Carolyn Joy Lee, Richard O. Loengard, Jr., Richard L. Reinhold and Michael L. Schler.

[2] Comments on this legislation are set forth in New York State Bar Association Tax Section, "Report on Proposed Legislation on Amortization of Intangibles (H.R. 3035)," 53 Tax Notes 943 (November 25, 1991)(the "1991 Report").

2. Contract Rights. The costs of acquiring contracts not incurred in connection with the acquisition of a trade or business are generally excluded from section 197 to the extent provided in regulations. These regulations are urgently needed in order for this exclusion to become effective.

3. Licenses. The regulations should discuss the tax consequences under section 197 of the right to use section 197 intangibles. The regulations should indicate when a license or any other contract to use a section 197 intangible is subject to section 197.

4. Leases and Tangible Property. Guidance is needed concerning when an intangible is separate from related tangible property, regardless of whether the property is leased.

5. Loss Disallowance Rules. The regulations should confirm that the loss disallowance rule will not apply to separately acquired section 197 intangibles. Guidance is also needed concerning the meaning of “series of related transactions” and the determination that a section 197 intangible has become worthless.

6. Anti-Churning Rules. The regulations should clarify the test which determines whether two corporations are related. In addition, regulations should clarify the application of the anti-churning rules to acquisitions of property by partnerships, section 708 terminations and section 338 elections. Further, the anti-churning rules should not apply to a repurchase of a section 197 intangible that otherwise would be subject to the anti-churning rules if such repurchase follows an arm's- length sale to an unrelated third party.

7. Deferred and Contingent Payments. The regulations should clarify the treatment of deferred and contingent purchase price payments for section 197 intangibles. Such payments should be added to the basis of section 197 intangibles to the same extent they would be added to the basis of tangible property. Moreover, to prevent the backloading of deductions, a fraction of each contingent payment (based on the fraction of the 15-year amortization period that has already elapsed) should be immediately deductible, and the remainder of the payment should be amortized over the remainder of the period.

II. Recommendations.

A. Self-Created Items.

In general, section 197 allows an amortization deduction with respect to any amortizable section 197 intangible. The deduction is taken ratably over 15 years and is the exclusive means of amortizing an amortizable section 197 intangible. The term amortizable section 197 intangible generally does not include section 197 intangibles created by the taxpayer.[3] The stated exceptions to this exclusion for self-created items are for covenants not to compete, licenses and permits granted by governmental units, and franchises, trademarks and trade names, as well as intangibles created in connection with a transaction involving the acquisition of assets constituting a trade or business or a substantial portion thereof.[4]

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[3] Sec. 197(c)(2).

[4] Sec. 197(c)(2).

1. Advertising. The regulations should confirm that advertising expenses are not part of the cost of a trademark or trade name, and therefore continue to be currently deductible.[5]

2. Substantial Portion of a Trade or Business. The exclusion from the definition of an amortizable section 197 intangible does not apply to intangibles created in connection with the acquisition of a "substantial portion" of a trade or business. The regulations should clarify what constitutes a "substantial portion" of a business for this and other purposes. The legislative history states that this determination is to be based on the nature and amount of the assets sold compared to the nature and amount of the assets retained, but that the relative values of assets sold and retained should not be determinative.[6] The legislative history also states that a group of assets constitutes a trade or business if they are the type of assets to which goodwill could attach. We believe that, except as otherwise specified in the legislative history,[7] a group of assets should constitute a "substantial portion" of a trade or business if and only if more than a de minimis amount of goodwill or going concern value could attach to the portion in the hands of either the buyer or the seller.[8] There is no reason to treat any acquisition of a group of assets in the same manner as the acquisition of a "whole" trade or business unless goodwill or going concern value could attach to these assets, because the distinctive feature of the acquisition of a trade or business that motivates much of section 197 is the difficulty of

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5 See, e.g., Rev. Rul. 92-80, 1992-2 C.B. 57. See also Rev. Rul. 94-77, 1994-51 I.R.B. 1.

6 H.R. Rep. No. 213, 103rd Cong., 1st Sess. 673, 678 (1993) (the "Conference Report").

7 Conference Report, 678.

8 See, e.g., Temp. Treas. Reg. Sec. 1.1060-1T(b).

allocating value between goodwill and other similar intangible assets. It might be argued that this approach negates the effect of including the term "substantial portion" in the statute, because any group of assets that would constitute a "substantial portion" under this approach would also constitute a "whole" trade or business under the general definition. While this may be true, the inclusion of the term "substantial portion" still appropriately precludes taxpayers from arguing that a group of assets to which goodwill or going concern value can attach should not be considered a trade or business because it is a part of a larger one.[9]

The issue of what constitutes a "substantial portion" is important in other contexts as well, and we believe that the term should be defined consistently for all purposes under - section 197. For example, under section 197(e)(4), a variety of contract and intellectual property rights are excluded if not acquired in connection with the acquisition of a "substantial portion" of a trade or business. In the absence of further guidance, it is not clear in what circumstances the acquisition of computer software, a film library, a governmental license, a patent, or a copyright could itself constitute the acquisition of a "substantial portion" of a trade or business. All of these items are specifically excluded from the definition of a section 197 intangible if acquired separately, but such items would constitute section 197 intangibles if they were found to constitute a "substantial portion" of a trade or business. Thus, buyers of these types of assets cannot know whether they should amortize them over 15 years or over a shorter period of time, and

[9] Self-created items are less likely to present issues regarding allocation of value than acquired existing intangibles. We believe, however, that the definition of "substantial portion" proposed in the text works best for all purposes of section 197, including contexts involving acquired intangibles.

some guidance on this question would be extremely helpful.[10] For example, under the legislative history, a trademark or trade name constitutes a "substantial portion,"[11] so that a patent acquired with a trademark would presumably not qualify for the exception. But it is not clear that this rule should apply to a trademark which constitutes a de minimis portion of the assets acquired.

The legislative history states that in making the determination whether assets were acquired as part of an acquisition of a trade or business, assets acquired by "related" persons are taken into account, while assets acquired simultaneously by unrelated persons are disregarded.[12] This should be confirmed by the regulations. Moreover, "related" is not defined, and the regulations should clarify whether the related person rules of section 197(f)(9)(C) (the anti-churning rule) or some other standard of relatedness applies in this context.

3. Costs Incident to the Acquisition of a Trade or Business. It is not clear whether the exclusion from the definition of an amortizable section 197 intangible for self-created items applies to the costs of contracts entered into by the taxpayer in connection with the acquisition of a trade or business. For example, questions could arise regarding commitment fees payable for a loan to finance such an acquisition. The exception contained in the statute for financial interests and interests under debt instruments[13] does not literally apply to these fees because it applies only to "existing" arrangements.

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[10] See the discussion of this issue in the 1991 Report at 956.

[11] Conference Report, 678.

[12] Conference Report, 678-679.

[13] Sec. 197(e)(1) and Sec. 197(e)(5).

These contracts should not be considered section 197 intangibles, regardless of whether an exception applies, because they do not fall within any of the enumerated categories of section 197 intangibles. The regulations should confirm this point.

B. Contract Rights.

To the extent provided in regulations, contracts not acquired as part of a business are excluded from the definition of a section 197 intangible if the contract has a fixed term of less than 15 years or if the cost would be recoverable under a method similar to the unit-of-production method.[14] Regulatory guidance is urgently needed here in view of the fact that the statute is not self-executing. Taxpayers should expect, for example, that the costs of acquiring an interest in a favorable supply contract, not in connection with the acquisition of a business, may be amortized over the term of the contract. However, unless the regulations state otherwise, such a contract will be subject to section 197 as a supplier based intangible.

The regulations should explain how the cost of a contract is calculated. For example, if in connection with acquiring a business a taxpayer pays a small amount to acquire rights under a supply contract, the potential application of section 197 should be limited to the amount paid to acquire these rights, but not to amounts paid pursuant to the contract itself.

The Conference Report suggests that a competitive bidding process for renewals will not be taken into account (i.e., the contract will be deemed to be renewable) in determining whether the contract has a fixed term unless the

[14] Sec. 197(e)(4)(D).

bidding process actually results in a contract with arm's-length terms.[15] It is difficult to understand how such a standard could possibly be applied to determine deductions during the base term because the bidding process will not yet have taken place. The regulations should state that renewals will not be taken into account if under the terms of the contract it can be reasonably expected that any renewals will be at an arm's-length, fair market value rate.[16]

The exclusion from the definition of a section 197 intangible for contracts with a fixed term of less than 15 years does not apply to assets acquired in connection with the acquisition of all or a substantial part of the assets of a trade or business. Presumably, the exclusion would apply to assets acquired in connection with the acquisition of stock of a corporation in the absence of a section 338 election, notwithstanding the fact that the corporation carries on a trade or business. The regulations should clarify this point.

Because the statute is not self-executing, the regulations providing guidance on the amortization of contracts with a fixed term of less than 15 years should be retroactive to the date of the enactment of section 197. If the regulations are not retroactive, they should explain what rule applies before they become effective.

C. Contracts to Use Section 197 Intangibles.

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[15] Conference Report, 681.

[16] This “reasonably expected” standard is currently applied under section 178 to determine the term of a lease for purposes of amortizing leasehold acquisition costs. Prior versions of section 178 used “more probable than not” and “reasonable certainty” of renewal standards.

In general, section 197 addresses the amortization of intangibles “acquired” by the taxpayer. In some cases, the taxpayer may not acquire outright legal ownership of the intangible itself, but simply the right to use it for some period of time; these rights may also be limited in other ways (e.g., geographically). These rights may be so extensive as to be an acquisition of tax ownership of the intangible, in which case the tax consequences under section 197 should mirror those of an acquisition of outright legal ownership of the intangible. Yet vexing problems remain.

First, it is not always clear whether what has been acquired is tax ownership or some lesser interest in the intangible. Some intangibles, such as patents, are well enough defined so as to permit an analysis of whether a purported licensee has acquired tax ownership. In other cases, there may be less certainty about whether retained interests prevent the transfer of tax ownership. Moreover, the mere existence of limitations in a contract does not necessarily indicate the existence of retained rights preventing the transfer of tax ownership, if the contract itself creates the intangible. For example, an employee's covenant not to compete can be limited by time, place, or line of business; but no matter how it is limited, what has been acquired is the entire covenant itself rather than some more limited interest in a potentially broader freedom from competition.

More fundamentally, if limited interests in intangibles are not subject to section 197, the application of a 15-year amortization period to intangibles with a shorter actual useful life creates a strong incentive for taxpayers to acquire more limited interests. For example, some technological know-how may be of greatest practical importance to a purchaser during the

initial five years; such a purchaser might seek to license the know-how for that period, with perhaps a fair market value renewal right thereafter. Provided that the licensing arrangement is structured in a manner that does not for tax purposes constitute an acquisition of the technology itself, if no section 197 intangible has been “acquired” by the taxpayer, the licensing cost would be either deductible currently under section 162 if the fees are paid over time or amortizable over 5 years under section 167 if paid up front.

The distinction between the acquisition of the intangible itself and the acquisition of a more limited interest only arises if the intangible is a section 197 intangible. Thus, in cases that do not involve the acquisition of a business, the distinction does not arise as to a license of an intangible such as a patent that is never a section 197 intangible in this context, and will not arise for interests in other contract rights to the extent that they are excluded pursuant to regulations under section 197(e)(4)(D).

In cases that do involve the acquisition of a business, the regulations will need to consider whether section 197 should apply to the acquisition of a limited interest in a section 197 intangible, such as an interest as licensee, where the taxpayer has not acquired tax ownership of the intangible itself. The exclusion of a license in connection with the acquisition of a business would raise the allocation questions that section 197 was designed to minimize. However, assuming an arm's length license fee, application of section 197 to a relatively short term license creates extremely back-loaded deductions for taxpayers.

As a matter of statutory construction, section 197(c)(1)(A) limits the application of section 197 to section 197 intangibles "acquired" by the taxpayer. Thus, section 197 would not seem to apply unless tax ownership of an intangible was acquired. However, section 197(d)(l)(C)(vi) includes in the definition of section 197 intangibles any item "similar" to the other intangibles described in section 197(d)(1)(C), and a license of an interest in an intangible might arguably be considered "similar" to ownership of the intangible. Section 197(9)/ moreover, authorizes regulations to prevent avoidance of the purposes of section 197.

The legislative history is ambiguous on this point. It clearly states that section 197 is generally not intended to affect items that are deductible under current law,[17] which would be true of license fees. However, it also states, in the context of the section 197(e)(4)(D) regulatory authority to exclude contracts with a fixed duration not acquired as part of a trade or business, that the regulatory authority should be exercised with respect to a five-year license of know-how because of the fixed duration.[18] This clearly implies that the license would be a section 197 intangible in the absence of the exercise of such regulatory authority.[19]

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[17] Conference Report, 673.

[18] Conference Report, 673-4.

[19] See also Conference Report at 684, stating that the cost of entering into a contract for the use of a section 197 intangible is not eligible for the exception for "self-created" intangibles, with the result that capitalized costs of entering into a license for the use of know-how or other section 197 intangible must be amortized under section 197. This conclusion presupposes that the license itself is a section 197 intangible. Moreover, the Conference Report at 679 n. 10 states, in the context of the exclusion for interests in a partnership, trust or estate, that a temporal interest in property cannot be used to convert a section 197 intangible into property that can be written off more quickly.

Because of this ambiguity in the statute and legislative history, regulatory guidance is clearly necessary on this question. For the same reason, we believe that any regulations that extend section 197 to cover licenses and similar arrangements should be prospective only. Moreover, such regulations should clearly delineate the types of licenses and other limited interests intended to be treated as section 197 intangibles. Finally, if the regulations require licensing fees to be capitalized and amortized, they should specify whether the unamortized balance of the fees can be written off when the license expires. The loss disallowance rule of section 197(f)(1) might be considered to preclude such a write-off, but allowing the write-off would properly reflect the termination of the licensee's interest in the intangible (assuming a fair allocation of price between the license and purchased assets).

D. Leases and Tangible Property.

Amortizable section 197 intangibles do not include any interest under an existing lease of tangible property.[20] The legislative history confirms that this exclusion for interests in a lease applies both to the lessee and to the lessor,[21] and the regulations should so provide.

Pursuant to section 197(f)(8), section 197 does not apply to any increment in value that (without regard to section 197) is properly taken into account in determining the cost of property which is not a section 197 intangible.[22] The Conference Report illustrates this provision by stating that, for example,

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[20] Sec. 197(e) (5) (A).

[21] Conference Report, 681.

[22] Sec. 197(f) (8).

no part of the cost of acquiring rental real estate is to be treated as goodwill, going concern value, or any other section 197 intangible.[23]

The rental real estate example appears to be illustrative of section 197(f)(8) only, and the regulations should so clarify that the principles of that provision apply equally to nonrental property. Even with real estate that is not rented, there can be increments in value that are properly taken into account in determining cost and one would not expect the absence of rental activity to render section 197(f)(8) inapplicable. The regulations should therefore provide, for example, that the costs of acquiring intangibles associated with real property (such as a building permit for a constructed building or the lessor's interest in a valuable lease encumbering the acquired property) are not treated separately for tax purposes but are instead included in the cost of the real property.[24]

Moreover, the Conference Report assumes that under present law no separate allocation can ever be made to goodwill or going concern value or other section 197 intangibles on a purchase of rental real estate. It is not clear that this is a correct statement of current law. It is possible, for example, that a shopping mall or an office complex may in fact have

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[23] Conference Report, 688.

[24] The Conference Report provides that no inference is intended as to whether any asset constitutes tangible or intangible property. Thus, any value associated with tangible property under prior law should continue to be so viewed for purposes of section 197. Conference Report, 673.

goodwill associated with it.[25] Thus, given the limited scope of section 197(f)(8) merely to incorporate current law, and the explicit intent of the legislative history solely to describe current law, the legislative history should not be viewed as a blanket prohibition against the identification, under the principles of prior law, of some portion of any acquisition costs of rental real estate as section 197 intangibles. Moreover, the regulations should clarify the treatment of nonrental real estate; given the absence of any legislative history on this issue, we expect that prior law controls in determining whether a separate allocation can be made to goodwill.

If rental real estate is nevertheless to be subject to distinctive treatment, a clear definition should be provided. Other definitions of rental income, such as the definitions under section 1362 or section 469, might be relevant for this purpose. The regulations would also need to address the consequences of acquiring a business that includes the rental of real estate but also provides substantial ancillary services. Also, a business that is owned and operated directly, such as a restaurant, might be acquired as part of a larger rental or office complex, just as the acquisition of a larger operating business (such as a retail store) might include leases granted to tenants for small portions of the facility.

E. Loss Disallowance Rule.

The general loss disallowance rule is intended to prevent taxpayers from circumventing the 15-year amortization period for section 197 intangibles acquired in the same or

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[25] In Revenue Ruling 77-403, 1977-2 C.B. 302, the IRS ruled that a real estate developer's covenant not to compete had no value under the facts under consideration, which implied that under other facts such a covenant could have value.

related transactions by disposing of some at a loss and retaining others.[26] The general loss disallowance rule achieves this result by denying recognition of any loss (but not gain) realized in the disposition of a section 197 intangible as long as any other such intangibles acquired in the same or related series of transactions are retained.[27] Taxpayers must make "appropriate adjustments" to the basis of such retained intangibles to the extent of the unrecognized loss.[28]

Regulations interpreting the general loss disallowance rule under section 197(f)(1)(A) should clarify the scope of the rule and provide safe harbors from the application of the rule where abuse is unlikely.

1. Separately Acquired Intangibles. The regulations should make clear that loss disallowance under section 197(f)(1)(A) will not apply to separately acquired section 197 intangibles. Section 197(f)(1)(A) would appear on its face not to apply to separately acquired intangibles. The Conference Report explicitly confirms this:

> these [loss disallowance] rules do not apply to a section 197 intangible that is separately acquired (i.e., a section 197 intangible that is acquired other than in a transaction or a series of related transactions that involve the acquisition of other section 197 intangibles). Consequently, a loss may be recognized upon the disposition of a separately acquired section 197 intangible.[29]

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[26] Sec. 197(f)(1)(A).

[27] Sec. 197(f)(1)(A)(i).

[28] Sec. 197(f)(1)(A)(ii). Presumably, the loss amount is to be amortized over the remaining 15-year amortization period of the retained intangibles, and the regulations should confirm this result.

[29] Conference Report, 685 n. 21.

Accordingly, the regulations should expressly exclude from the application of the loss disallowance rule any disposition of "separately acquired section 197 intangibles." In addition, the regulations need to define this term to clarify the distinction between separately acquired section 197 intangibles and section 197 intangibles acquired in the same transaction or series of related transactions as other intangibles.

For example, consider the acquisition by a large pharmaceutical company over a six-month period of the assets of three small biotechnology businesses each from different and unrelated sellers pursuant to a plan to expand the acquiror's product development pipeline. Assume that, a few months later, the assets of one of the three acquired companies (including all of its intangibles) become worthless. The literal terms of the loss disallowance rule could apply to this case. Absent further guidance, the term "series of related transactions" might be read to include this series of related acquisitions even though they offer little opportunity for abuse. However, because each of the sellers is different and unrelated, no part of the purchase price of one acquisition can be shifted to the other acquisitions so as to shorten the amortization period artificially.

The Committee recommends that the regulations define the term "separately acquired section 197 intangible" to exclude from the application of the loss disallowance rule any section 197 intangibles not acquired (i) in the same transaction as one or more other section 197 intangibles, or (ii) in separate transactions but as part of a "series of related transactions" in which one or more other section 197 intangibles are acquired.

The Committee also recommends that the regulations provide a definition of "series of related transactions."[30] In providing this definition, the regulations should identify safe harbors such that specified transactions will be expressly excluded from the definition. The regulations should base the safe harbors on several factors including, e.g., (i) the timing of the transactions and (ii) the relationship of the parties involved in the transactions. Whether or not the intangibles relate to similar lines of business also should be relevant, at least where there is little potential for misallocation of price.

Timing provides the simplest basis for segregating related and unrelated transactions. The regulations should provide a bright-line period of, say, one year, so that transactions would be presumed not to be part of a series of related transactions unless they are contracted for or take place within this time period.

The relationship of the parties involved in the transactions is another basis for distinguishing related and unrelated transactions. As illustrated by the pharmaceutical company example described above, no two acquisitions should be part of a "series of related transactions" where the sellers are unrelated. Even where the sellers are related and the transactions take place within a short period of time, a presumption that the transactions are related should be rebuttable based on all the facts and circumstances. For example, consider transactions within one year between subsidiaries of two large multimedia corporations, A and B. In the first transaction, the publishing subsidiary of A buys the assets of a school textbook publishing division of B. Some months later, in the

[30] In this regard, the regulations might also clarify that "series" means "two or more" rather than "more than two."

second transaction, the recording subsidiary of A, headquartered in a different city and sharing no common personnel with the publishing subsidiary, buys the classical music label and library from B's recording subsidiary. Assume that the transactions were separately negotiated.

A's subsidiaries in this example are treated under section 197(f)(1)(C) as a single taxpayer for purposes of the loss disallowance rule.[31] Unless the two transactions can be shown not to be part of a "series of related transactions", the loss disallowance rule will apply. This is clear from an example contained in the Conference Report:

> a loss is not to be recognized by a corporation upon the disposition of a section 197 intangible if after the disposition a member of the same controlled group as the corporation retains other section 197 intangibles that were acquired in the same transaction (or a series of related transactions) as the section 197 intangible that was disposed of.[32]

The Committee recommends that the regulations provide that transactions involving a single corporation or members of a controlled group (i) will be presumed to be related (and thus constitute part of a "series") if the transactions (a) occur within a year of each other and (b) involve acquisitions from related sellers and (ii) will otherwise be presumed to be unrelated. However, it should be possible under the regulations to overcome a presumption of relatedness where the acquisitions involved distinct lines of business and were separately negotiated.

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[31] "All persons treated as a single taxpayer under section 41(f)(1) shall be so treated for purposes of [section 197(f)(1)]." Sec. 197(f)(1)(C).

[32] Conference Report, 685 (emphasis added).

2. Worthless Intangibles. The regulations should clarify what constitutes the "disposition" of a worthless intangible. The Conference Report provides:

> the abandonment of a section 197 intangible or any other event that renders a section 197 intangible worthless is to be considered a disposition of a section 197 intangible.[33]

The statute, in stating that the loss disallowance rule applies as long as a section 197 intangible is "retained", creates some uncertainty as to whether a loss deduction is available if the last of a group of acquired intangibles becomes worthless but is "retained":

> [i]f there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained (i) no loss shall be recognized by reason of such disposition (or such worthlessness).[34]

The first part of this sentence implicitly recognizes that a "worthless" intangible has, in effect, been disposed of and thus is no longer retained for purposes of Section 197. Despite the ambiguity of the second part of the sentence, the regulations should make explicit that when an intangible becomes worthless it ceases to be "retained" for purposes of the loss disallowance rule.

In addition, the regulations should clarify whether standards established prior to the enactment of section 197 will apply to recognizing the worthlessness of section 197 intangibles. For example, consider the acquisition of a business

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[33] Conference Report, 685 n. 20.

[34] Sec. 197(f)(1)(A)(i).

that makes an over-the-counter diet pill and includes three intangibles -- a patent (on the active ingredient in the product), goodwill and the business' going concern value. Just after the acquisition, the FDA bans sales of the product. Assuming that the FDA action renders the product worthless, does it also render the patent worthless? Even if the FDA's action also renders the goodwill worthless, does going concern value survive the worthlessness of goodwill? In this example, the capacity to produce the product is not eliminated and presumably the employees and equipment could be used to make other products. Does this mean it still has going concern value?

Although the resolution of such issues could be an interesting intellectual exercise, an easily administrable standard for "worthlessness" is needed for purposes of the regulations. Some of these questions may be resolved simply by applying general standards for recognizing loss to the loss disposition rules of section 197. Others may require new rules. For example, prior to section 197, a deduction for the loss associated with abandoned goodwill was allowed, but only in connection with the disposition of the entire business (and all its assets) associated with that goodwill.[35] In such cases, the abandonment of the business and assets was itself evidence of the abandonment of goodwill. However, under section 197, the issue may be whether goodwill is retained (i.e., is not yet worthless) despite the abandonment of the other assets or, alternatively, whether goodwill is worthless despite the retention of other assets. In this regard, the Committee recommends that the regulations specify the extent to which abandonment of section 197 intangibles will be governed by rules under section 165.

[35] See, e.g., Rev. Rul. 57-503, 1957-2 C.B. 139.

The regulations should also address whether the loss disallowance rule should apply at all where the disposition of a section 197 intangible results from circumstances that are involuntary or are otherwise in the nature of a casualty. There is no potential for selective realization of losses where unanticipated events in the nature of a casualty and outside of the control of the taxpayer cause one of several intangibles acquired at the same time or as part of a series of related transactions to become worthless. For example, consider the diet pill example above. The goodwill (or the trade name) associated with the product might become worthless if a new lethal disease (with severe weight loss as one of its symptoms) comes to be referred to by a name that closely resembles the name of the product. Although the involuntary nature of a casualty provides some justification for relief from the loss disallowance rule, there is still potential for tax planning and disputes with the Service over the allocation of basis to the intangible that was subject to the casualty. Moreover, an intangible can become worthless for other, equally involuntary reasons that do not involve a casualty, such as the development of a competing technology or even, in the case of an intangible (such as a covenant not to compete) that has a limited term, the mere passage of time. If there is to be more favorable treatment for losses that result from a casualty or other event outside the control of the taxpayer, the regulations should specify whether the standards of section 165 or section 1033 should apply, or some other rule.

3. Sequential Dispositions. There is a possibility for inconsistent treatment produced by the sequence of dispositions of section 197 intangibles acquired in the same or related transactions. For example, consider the acquisition of three section 197 intangibles in the same transaction for $ 100 each.

If one drops in value to $ 50 and another appreciates to $ 150, selling both yields very different results depending on the sequence of the sales. If the loss intangible is sold first, the $ 50 loss amount is added proportionately to the remaining bases of each of the two "retained" intangibles. This gives each a basis of $ 125, presumably resulting in a gain of $ 25 on the sale of the second intangible. However, if the appreciated intangible is sold first, the result is a gain of $ 50 and the loss amount on the sale of the second is added to the basis of the third, and only remaining intangible. Selling the appreciated intangible second shelters half the gain that would be recognized were the order of the sales reversed.[36]

This inconsistency would be eliminated if, following the disposition of an asset at a loss, the basis of the other intangibles acquired in the same transaction or series of related transactions were increased only for purposes of amortizing such loss over the remaining 15-year amortization period until the disposition of the last remaining asset. Thus, in the example set forth above, the $ 25 disallowed loss would be disregarded for purposes of determining gain or loss on the sale of the second asset. Upon the sale of the second asset, $ 50 in gain would be recognized, and the $ 25 disallowed loss originally allocated to the second asset would be added to the basis of the third asset. Upon a sale of the third (and last) asset, the full $ 50 disallowed loss (except to the extent previously amortized) would be taken into account, with the result that the loss would be fully recognized at that time.

The Committee does not recommend that the regulations adopt this approach, however; addressing the inconsistency in

[36] See the discussion of this issue in the 1991 Report, 958.

this manner would exacerbate the harshness of the loss disallowance rule without furthering its purposes. On balance, therefore, the Committee recommends that the regulations confirm a straightforward application of the statute, with whatever inconsistencies may arise with sequential dispositions, rather than a rule that mandates uniform results, but at a cost of needless loss deferral.

4. Related Entities. Section 197(f)(1)(C) provides that "[a]ll persons treated as a single taxpayer under section41(f)(1) shall be so treated for purposes of this paragraph [section 197(f)(1)]." The Conference Report indicates that the purpose of this rule is to prevent losses from being recognized by one member of a controlled group while another group member holds section 197 intangibles acquired in the same transaction or series of related transactions.[37] The Conference Report states that it is anticipated that the regulations will provide rules for taking into account the amount of any loss not recognized under this rule, suggesting that instead of reallocating the disallowed loss amount to the basis of the other retained assets, the loss amount be amortized over the remaining years left in the 15-year amortization period of the asset.[38] If the regulations adopt this approach, they should clarify that under these circumstances, any such remaining losses will be deductible when the other group members would otherwise have recognized less gain on the disposition of their section 197 intangibles acquired with that intangible.

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[37] Conference Report, 685-686.

[38] As a practical matter, implementation of this suggestion would appear to make little difference for federal income tax purposes if the related parties file a consolidated income tax return, although it presumably could create significant state tax differences.

5. Nonrecognition Transfers. The regulations need to clarify how the loss disallowance rule will apply if a section 197 intangible is disposed of in a substituted basis transaction. For example, consider the acquisition by A, an individual, of an unincorporated business, B, including several amortizable section 197 intangibles. Some period after the acquisition, A contributes some of these intangibles to its controlled corporation, Newco, in exchange for Newco's stock in a nonrecognition transfer under section 351. Shortly thereafter, A sells all the Newco stock at a loss. A will have circumvented the loss disallowance rule unless this loss amount is added to the basis of the retained intangibles acquired from B.

Under the statute, the loss disallowance rule does not prohibit this result. The loss disallowance rule applies only to the "disposition of any amortizable section 197 intangible", not to the disposition of stock that may represent an interest in intangibles subject to the loss disallowance rule. Moreover, the general rule for nonrecognition transactions,[39] namely that "the transferee shall be treated as the transferor" following a nonrecognition transfer, does not address the question of how properly to treat the transferor.

Congress gave broad authorization in section 197 for the creation of regulations that "prevent the avoidance of the purposes of this section through related persons or otherwise."[40] The Committee recommends that the regulations apply the loss disallowance rule to the disposition of property acquired in connection with a nonrecognition transfer of a section 197 intangible. This could be accomplished by expanding the

[39] Sec. 197(f)(2).

[40] Sec. 197(g).

definition of “disposition” under section 197(f)(1)(A) on which losses would be disallowed to include the disposition of stock or other property acquired in exchange for section 197 intangibles to the extent its basis reflected the unamortized basis of such intangibles.

The difficulties with a rule such as this should not be minimized, however. For example, taxpayers could potentially circumvent this rule by contributing an unrelated appreciated asset together with the section 197 intangible in a nonrecognition transaction, and using the unrealized loss on the section 197 intangible to shelter the gain on the other asset. This result can be blocked by an “anti-stuffing” rule similar to that provided under the loss disallowance provisions of the consolidated return regulations.[41] However, other inherent difficulties with the proposed rule could not so easily be avoided. Suppose, for example, that the taxpayer acquiring a business immediately transfers a portion of the business (including some intangibles) to a newly formed (or preexisting) subsidiary, and some time thereafter sells the stock of the subsidiary at a loss. Is the loss always to be disallowed, never to be disallowed, or to be disallowed to the extent that the contributed intangibles are in fact depreciated at the time of sale? We have no good answer to this question.

F. Anti-Churning Rules.

The anti-churning rules are intended to prevent taxpayers from applying section 197 to certain otherwise nonamortizable intangibles by transferring them in circumstances where the owner or user has not in substance changed. The anti-

[41] Treas. Reg. Sec. 1.1502-20(e)(2).

churning rules achieve this by excluding certain intangibles acquired under such circumstances from the definition of amortizable section 197 intangibles.

1. Test for Related Corporations Clarified. Under the anti-churning rules, the term "amortizable section 197 intangible" excludes an intangible acquired by the taxpayer after the enactment of section 197 if the intangible was held or used on or after July 25, 1991, and before the date of enactment by the taxpayer or a "related person."[42] Two persons will be considered related for purposes of the anti-churning rules if they bear a relationship to each other specified in section 267(b) or section 707(b)(1), or if they are engaged in trades or businesses under common control within the meaning of sections 41(f)(1)(A) and (B).[43] The last sentence of section 197(f)(9)(C) says that for purposes of determining whether two persons are related parties under sections 267(b) and 707(b)(1) (but not under section 41(f)(1)(A)), "20 percent" shall be substituted for "50 percent."

Section 267(b)(3) defines related persons as two corporations which are members of the same controlled group as defined in section 267(f). Section 267(f), in turn, references the section 1563(a) definition of controlled group but reduces the "at least 80 percent" threshold contained in section 1563(a) to a "more than 50 percent" standard.

It is unclear whether the last sentence of section 197(f)(9)(C) applies to reduce the ownership threshold for two corporations from "more than 50 percent" to "more than 20

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[42] Sec. 197(f) (9) (A).

[43] Sec. 197(f) (9) (C).

percent." One could argue that the reduction to 20 percent should apply to all relationships listed in section 267(b), thereby reducing the chain of ownership test for two corporations to "more than 20 percent." Alternatively, there is an argument that the reduction to a 20 percent threshold provided for in section 197(f)(9)(C) does not apply to section 267(f) through section 267(b) and, accordingly, corporations with a common chain of ownership of 50 percent or less are not related parties for purposes of the anti-churning rules. This argument is based on the fact that while section 267(b)(3) provides a definition for two related corporations, it does not itself contain a "more than 50 percent" standard. Thus, one interpretation of the last sentence of section 197(f)(9)(C) (i.e., substitute "more than 20 percent" for "more than 50 percent" in the several places it appears in section 267(b)) would not lower the related party threshold for two corporations to 20 percent. In addition, applying a 20 percent threshold to controlled corporations pursuant to section 267(b) seems to render meaningless the reference to section 41(f)(1), which provision incorporates a 50 percent threshold for groups of controlled corporations (under section 41(f)(1)(A)) that clearly is not reduced to 20 percent.[44]

Notwithstanding these arguments, there would appear to be no sound policy reason for having a 50 percent ownership threshold for purposes of the related party definition in the case of chains of "C" corporations and a 20 percent threshold in all other cases. Thus, the Committee recommends that the regulations clarify that the 20 percent threshold applies in all cases.

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[44] See Jack S. Levin and Donald E. Rocap, "A Transactional Guide to New Code Section 197," 61 Tax Notes 461, 469 (October 25, 1993).

2. Acquisitions by a Partnership. The application of the anti-churning rules to sales of property to partnerships and sales of partnership interests appears to depend upon form rather than substance. As a threshold matter, the Committee does not believe that the application of the anti-churning rules in this context should turn on the form of the transaction pursuant to which a section 197 intangible is acquired by a partnership. Conceptually, the Committee believes that to the extent that amortization deductions related to a basis step-up with respect to a section 197 intangible are allocated away (by law or pursuant to the partnership agreement) from the partner that formerly owned the intangibles (and that paid a tax in connection with the step-up), there generally is no abuse that needs to be addressed by the anti-churning rules.

Nevertheless, the anti-churning rules appear to contemplate that form will dictate result in the context of a sale of property to a partnership or a sale of a partnership interest. Given this structure of the statute, the regulations should include examples to illustrate and compare the effect of (i) a taxable actual or "disguised" sale of intangibles to a related partnership under section 707(a)(2)(B) which is funded by an unrelated third party, (ii) a sale of a partnership interest in a related partnership to an unrelated third party accompanied by a section 754 election and a resulting basis step-up under section 743(b), and (iii) a sale of intangible assets to an unrelated third party followed by a related contribution of such assets by the purchaser to a partnership related to the seller.

The first example should illustrate that an actual or disguised sale of assets by a partner to a partnership resulting in a basis step-up of the intangibles that are sold to such partnership will implicate the anti-churning rules if the

"selling" partner and the partnership are related either before or after the sale.[45] The disguised sale example should be drafted so that the cash used to generate disguised sale treatment is contributed to the partnership (and then distributed to the selling partner) by an unrelated third party at the same time that the selling partner contributes the intangibles. The net economic effect of the transaction is the formation of a partnership with an unrelated third party in which the selling partner receives cash in exchange for a portion of its interest in the partnership.

The second example should be based on facts similar to those contained in the first example, but in this example the selling partner would first form a partnership (perhaps with a related party such as a subsidiary corporation) and then transfer intangible assets to such partnership in a tax-free transaction under section 721. After the partnership is formed, the transferor/partner would sell a portion of its interest in the partnership to an unrelated third party for cash. The partnership would make an election under section 754, thereby allowing the partnership to increase its basis in the intangible assets contributed by the selling partner under section 743(b). Unlike in example one, however, in this example the basis step-up under section 743(b) would not be subject to the anti-churning rules because for purposes of the anti-churning rules, determinations are made at the partner level and each partner is treated as having owned and used its proportionate share of the partnership property.[46] Moreover, the example should state that the choice of form (i.e., a sale of a partnership interest rather than a disguised sale of assets to the partnership) does not implicate

[45] Sec. 197(f)(9) and Sec. 707(b)(1).

[46] Sec. 197(f)(9)(E); Conference Report, 692.

the general anti-abuse rule contained in section 197(f)(9)(F) even though the net economic result is the same as in the first example.

The third example should illustrate an outright sale of a portion of the intangible assets to an unrelated third party for cash followed by the previously contemplated contribution by both the seller and purchaser of their respective portions of such intangible assets to a partnership to which the seller will then be related. The result under this example is unclear. Under section 197(f)(2), the partnership steps into the shoes of the partner for purposes of applying section 197, which would, without more, indicate that the partnership is entitled to amortize the portion of the intangibles contributed by the purchaser because the purchaser did not own or use the intangibles prior to the enactment date. The general anti-churning rule in section 197(f)(9)(A)(i), however, arguably would trump section 197(f)(2) because the selling partner held the intangible in question prior to the enactment date. For simplicity, the Committee recommends that the anti-churning rules apply in full to the intangible, even though up to 80 percent of the deductions may be allocable to the new partner. Allowing amortization for the new partner's share of the partnership's basis but not for the continuing partner's share would unduly complicate the rules governing maintenance of capital accounts under the section 704 regulations.[47]

In a related context, under section 197(f)(9)(B), a special rule applies where the anti-churning rules apply solely because the 50 percent related party threshold is reduced to 20

47 This complication does not arise with respect to a basis step-up under section 754 because the associated amortization deductions do not affect capital accounts. Treas. Reg. Sec. 1.704-l(b)(2)(iv)(m)(2).

percent under section 197(f)(9)(C). Under this special rule, if the person from whom the taxpayer acquires the intangible elects notwithstanding any other provision of the Code to recognize gain on the disposition of the intangible, and to pay a tax on such gain at the highest rate of income tax applicable to such person, then the anti-churning rules will apply only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized on the transfer.

However, the statute does not explicitly state how much gain must be recognized by the transferor making the election. The regulations should clarify that under this provision, the transferor is required to pay tax on all realized gain whether or not recognized under the usual provisions of the Code. Thus, for instance, if the transferor contributed intangibles to a corporation in a section 351 transaction in exchange for stock and cash, the corporation would be permitted to use the special rule only if the transferor elects to pay a tax on all realized gain, not only on the gain recognized under section 351.

Furthermore, the regulations should clarify that the rate of tax which the transferor is required to pay is the highest rate of tax applicable to the sale of the intangible. Thus, in the case of an unamortized intangible, the applicable tax will generally be a tax computed at capital gain rates; in the case of an amortized intangible, there frequently will be an ordinary income element (to the extent of recapture), and there may be a capital gain element as well.

3. Intangible Should Lose Identity in Sale to Third Party. The anti-churning rules appear to be overly broad in their potential application where a taxpayer sells an intangible asset

to a third party and subsequently, in an unrelated transaction, reacquires the "same" intangible in an arm's-length transaction.

For example, suppose a taxpayer ("S") sells a trade name to an unrelated party ("B") in 1994 in an arm's-length transaction. Many years later, S (or a related party for purposes of the anti-churning rules) buys the substantially appreciated trade name back from B (or a subsequent transferee) for non-tax business reasons and in a transaction not contemplated at the time of the original sale. Under a broad reading of section 197(f)(9)(A), the anti-churning rules forever prohibit S (or a party related to S) from amortizing the repurchased goodwill for the trade name because it was once held by S during the anti-churning period (i.e., the period from on or after July 21, 1991 until on or before the enactment date). This result clearly extends beyond the purpose for enacting the anti- churning rules because the two independent, arm's-length transactions were not consummated to convert non-amortizable intangibles into section 197 intangibles, but instead were effected for non-tax business reasons.[48]

Because identification of a particular intangible is subject to conflicting interpretations and is not spelled out in section 197, the regulations should adopt the position that an arm's-length sale of intangibles to an unrelated third party constitutes a sufficient change in the nature of the intangible so that the intangible's identity is cut off. Thus, if the original seller (or a party related to the seller) repurchases intangible assets that it previously sold in an arm's-length •transaction and the repurchase was not contemplated at the time

[48] The same issue would arise on the facts of the proposed third example in F.2 above if the contributions of the intangible to the partnership were unrelated to the earlier transactions.

of the original sale, the anti-churning rules would not apply because the original seller would not be deemed to have held "the intangible" prior to the enactment date.

4. Partnership Termination. For purposes of the anti-churning rules, the resolution of whether the user of intangible property changes as part of a transaction is to be determined in accordance with regulations to be prescribed by the Secretary.[49] The regulations should include an example illustrating that following the sale of an 50 percent or greater interest in a partnership to an unrelated party the new partnership deemed to exist following the constructive termination of the old partnership will not be related to the old partnership for purposes of the anti-churning rules. For example, suppose a partnership has owned and used substantial goodwill prior to the date of enactment of section 197, and there have been no transfers of interests. In 1994, a 51 percent interest in the partnership is sold to an unrelated party causing the partnership to terminate pursuant to section 708(b)(1)(B). The termination results in a constructive liquidation of the partnership and a recontribution of the assets by the partners to a "new" partnership. The old and new partnerships should not be treated as related for purposes of the anti-churning rules. The rules should nonetheless apply if the continuing partners retain at least a 20 percent interest. If the continuing partners retain less than a 20 percent interest, the partnership's section 197 intangibles should be fully exempt from the anti-churning rules, even to the extent that amortization deductions are allocated to the continuing partners.[50]

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[49] Sec. 197(f)(9)(A)(penultimate sentence).

[50] Similar treatment is provided by the proposed regulations applying the ACRS anti-churning rules. Prop. Treas. Reg. Sec. 1.168-4(d)(6)(ii).

5. Section 338 Election. In addressing the interaction of the anti-churning rules and section 338 elections, the legislative history indicates that the anti-churning rules will not apply to deemed sales under section 338:

> it is anticipated that in the case of a transaction to which section 338 of the Code applies, the corporation that is treated as selling its assets will not to [sic] be considered related to the corporation that is treated as purchasing the assets if at least 80 percent of the stock of the corporation that is treated as selling its assets is acquired by purchase after July 25, 1991.[51]

The regulations should confirm this point but should also make clear that the anti-churning rules may nonetheless apply if the purchaser and the seller of the stock are related for purposes of the anti-churning rules. Although the definition of "purchase" in section 338 excludes purchases from a related party, a seller that is unrelated under section 338 may still be related under section 197(f). For example, corporations with more than 20 percent but less than 50 percent common ownership are related under section 197(f) but not under section 338.

G. Deferred and Contingent Payments.

The statute does not expressly address how to amortize section 197 intangibles that are acquired for a deferred or contingent obligation. The Committee believes that the rules for such intangibles should be the same as the rules for tangible property, as suggested by the legislative history.[52] Thus, a deferred or contingent obligation should be includible in the basis of a section 197 intangible to the same extent that it would be includible in the basis of tangible property.

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51 Conference Report, 692, n. 32.

52 Conference Report, 685.

Moreover, if an intangible is purchased for fixed deferred payments, the regulations should confirm that the entire principal amount of those payments should be included in basis at the time of purchase and amortized over a single 15-year period beginning at the time of purchase. If the deferred payments include imputed interest after application of section 1274, the reduced imputed principal amount would go into the basis of the intangible, and the remaining imputed interest amount would be amortized as interest deductions over the term of the debt (rather than over 15 years).

The Conference Report states that contingent payments are to be taken into account when fixed and amortized over the remaining term of the original 15-year amortization period.[53] This approach, while consistent with the treatment of tangible assets in the proposed ACRS regulations,[54] unreasonably backloads the deductions. For example, suppose contingent payments for an amortizable section 197 intangible are to be paid over a 5-year period. At the end of this period, the precise amount to be paid is known, and one might expect, based on the statutory scheme, that the taxpayer's cumulative deductions over this period would be one-third of the total, since one-third of the amortization period has elapsed. Instead, under many circumstances as little as one-sixth or less of the total deductions will be allowed. Moreover, this backloading of deductions does not necessarily

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53 Conference Report, 685. The Conference Report, at 677, also states that amounts paid or incurred for a covenant not to compete after the taxable year in which the covenant is entered into can be amortized only over a period beginning with the month in which such amounts are paid or incurred. This is presumably based on the theory that future payments under a covenant are always contingent, because they depend on the continued observance of the covenant by the recipient of the payments.

54 Prop. Treas. Reg. Sec. 1.168-2(d)(3)(ii), Example 2.

benefit the government; for example, taxpayers with expiring loss carryforwards can take advantage of the deferral.

In the 1991 Report, the Tax Section recognized that allowing current deductibility for contingent payments, following the Associated Patentees[55] rule of current law, would be inconsistent with the statutory objective of forcing deductions to be claimed over a 15-year period even for intangibles with a demonstrably shorter useful life. Any improper frontloading, however, can be eliminated by a rule that allows taxpayers to deduct a fraction of each contingent payment equal to the fraction of the amortization period that has already elapsed, and to amortize the balance over the remaining term of the amortization period. Such a rule would be more faithful to the purpose of the statute than the rule set forth in the Conference Report.

Regardless of which rule is adopted, it should apply only to payments that become fixed after the taxable year in which the intangible is acquired. Contingent payments that become fixed during the year in which the intangible is acquired should be included in basis and amortized in the same manner as payments fixed at the outset.[56] In addition, payments made after the 15 year amortization term has expired should be deductible when made.

H. Other Issues.

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[55] Associated Patentees, Inc. v. Commissioner, 4 T.C. 979 (1945), acq., 1959-2 C.B. 3.

[56] The Conference Report, at 677, makes this point clear in the case of a covenant not to compete.

1. Non-Amortizable Section 197 Intangible. Section 197(b) states that no depreciation or amortization deduction is allowed under other sections of the Code with respect to an amortizable section 197 intangible.[57] The statute is silent with respect to the treatment of section 197 intangibles that are not amortizable under section 197, such as self-created items. However, it seems unlikely that Congress intended to disallow all deductions for, e.g., a self-created patent. The regulations should confirm that the cost of acquiring a section 197 intangible which is not an amortizable section 197 intangible may still be deductible or amortizable under other principles of tax law.[58]

2. Definition of Section 197 Intangible. Section 197(d) enumerates several categories of section 197 intangibles, and then includes in the list "any other similar item.1,[59] The regulations should give examples of items that are considered "similar" to the enumerated section 197 intangibles, or should provide at least some guidelines for determining similarity for this purpose.

3. Covenants Not to Compete. The 15-year amortization requirement of section 197 applies to covenants not to compete as well as to arrangements that have "substantially the same effect as a covenant."[60] For example, an arrangement whereby the former owner of a business continues to perform services for the

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[57] Sec. 197(c)(2).

[58] The legislative history states that no inference is intended regarding deductions for the cost of an intangible that is not a section 197 intangible but does not explicitly state that no inference is similarly intended for a section 197 intangible that is not an amortizable section 197 intangible. Conference Report, 673.

[59] Sec. 197(d)(1)(C)(vi).

[60] Sec. 197(d)(1)(E).

business is considered equivalent to a covenant to the extent the payments exceed "reasonable compensation" for the services.[61] While this rule is necessary to avoid abuse in labeling payments to former owners as deductible compensation rather than as amortizable payments for a covenant, it will revive factual litigation, which section 197 sought to avoid, on what constitutes reasonable compensation.[62] Is a signing bonus (e.g., one paid to a former owner) to be treated like a covenant on the grounds that it has substantially the same effect?

Some tax avoidance potential is created by the possibility that a covenant not to compete may be disguised as a contract for continued employment, with the result that it would fall outside the scope of section 197. Indeed, some portion of the compensation paid under any employment contract might be said to be attributable to a covenant not to compete, since every contract contains such an implicit if not explicit covenant. However, we believe that the regulations should provide that the cost of an employment contract should be amortized over the life of the contract, notwithstanding the presence of an implicit, or even an explicit, covenant not to compete, if the payments do not exceed reasonable compensation for services to be performed.[63]

A covenant not to compete is a section 197 intangible if it is entered into in conjunction with the direct or indirect acquisition of an interest in a trade or business.[64] The

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[61] Conference Report, 677.

[62] Litigation can also be expected to continue on whether purchase price should be allocated to a covenant or to the stock acquired in conjunction with the covenant.

[63] This would still permit the Service to argue, for example, that payments under a consulting contract with an attached covenant were primarily for the covenant.

[64] Sec. 197(d)(1)(E); Conference Report, 677.

regulations should clarify whether section 197 applies to a covenant created in conjunction with an acquisition of any interest in a trade or business, no matter how small, or whether it applies only to the acquisition of a controlling interest. Presumably, section 197 is meant to apply only to the acquisition of a controlling interest, and the regulations should confirm this.

The statute assumes (and the Conference Report states)[65] that the costs of a covenant not to compete must be capitalized even if taxpayers elect to pay the cost of a covenant ratably over its term rather than in a lump sum up front. The regulations should confirm that these costs are still amortizable under section 197 and not deductible under section 162.

A covenant not to compete is subject to the general rule in section 197(f)(1)(A) disallowing a loss on disposition or worthlessness until the disposition of all amortizable section 197 intangibles acquired in the same transaction or series of related transaction. In addition, however, section 197(f)(1)(B) provides a special rule for covenants not to compete (or other similar arrangements) described in section 197(d)(1)(E). The special rule for such covenants is that they "in no event shall . . . . be treated as disposed of (or becoming worthless) before the disposition of the entire interest [in a trade or business or substantial portion thereof]. . . in connection with which such covenant (or other arrangement) was entered into."[66] Thus, even if all the relevant section 197 intangibles are disposed of, a covenant not to compete can never be written off over less than 15 years unless the other assets of the relevant trade or

[65] Conference Report, 677.

[66] Sec. 197(f) (1) (B).

business are also disposed of. For example, where a covenant is entered into in connection with a stock acquisition, no loss deduction is allowed for the covenant until the "entire interest" in the stock is disposed of.

The regulations should clarify the application of this rule where one buyer acquires more than one trade or business in the same or related transactions and disposes of all the section 197 intangibles (including covenants not to compete) in all such businesses. To the extent that a covenant not to compete relates to more than one such business, the amount paid for such covenant should be allocated between the two businesses and, where one of the businesses is disposed of, the regulations should provide that the remaining amount allocated to the covenant relating to the business that was disposed of may be written off. For this purpose, among the possibilities would be to treat businesses separately if they would be so treated under the passive activity rules, or under the tests of section 355 and section 1060.

4. Trademarks. The inclusion of trademarks, franchises and trade names in the definition of section 197 intangibles should not preclude taxpayers from deducting contingent payments under section 1253 when the requirements of that section are met (i.e., the contract calls for annual payments or a fixed formula).[67] The regulations should therefore clarify that if a payment meets the requirements of section 1253(d)(1), it should not be treated as amortizable over a 15-year period solely because it may also represent payment for the goodwill inherent in the franchise.

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[67] Sec. 197(d)(1)(F), Sec. 197(f)(4)(C) and Sec. 1253(d)(2).

5. Receivables. In accordance with the Conference Report, the regulations should clarify that accounts receivable or similar rights to income for goods or services provided to customers prior to the acquisition of the trade or business are not customer based intangibles. Any portion of the purchase price allocable to such receivables is to be allocated among the receivables and taken into account as payment is received under the receivable or as the receivable becomes worthless.[68]

6. Exclusions Generally. For each item of exclusion listed in section 197(e), it would be helpful if the regulations were to provide some guidance on how, if at all, the item should be deducted. The only guidance provided in the legislative history is for rights of fixed term or duration, which the Service is authorized to exclude from the scope of section 197 intangibles.[69] If (as we believe proper) the excluded items are to be deducted in accordance with prior law, the regulations should expressly state this.

7. Financial Interests. Amortizable section 197 intangibles do not include any interest in a corporation, partnership or trust.[70] Thus the cost of acquiring stock, partnership interests or interests in trusts or estates does not qualify for 15-year amortization. Notwithstanding this rule, however, an acquiror of a partnership interest should be entitled to a distributive share of the partnership's amortization of section 197 intangibles and to increase the basis of those

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[68] Conference Report, 676 and n. 4.

[69] Conference Report, 676-681.

[70] Sec. 197(e) (1) (A).

intangibles if an election under section 754 is in effect or upon a section 708 termination.[71]

A section 197 intangible also does not include any interest under an existing futures contract, foreign currency contract, notional principal contract or other similar financial contract. The regulations should define "other similar financial contracts", and in doing so should confirm that commodity futures contracts are not section 197 intangibles.

As discussed above, it is not clear whether the costs of entering into a new contract are excluded from the definition of a section 197 intangible, whether because they are self-created items, because they are not existing contracts or for some other reason. The regulations should explain whether such costs are excluded and, if so, for what reason.

8. Patents and Copyrights. A section 197 intangible generally includes any patents, copyright, formula, process, design, pattern, know-how, format or other similar item.[72] A copyright or patent acquired outside the context of a business acquisition is excluded from the definition of a section 197 intangible, but the other items listed in the preceding sentence are not mentioned.[73] The regulations should state whether these other items are also excluded if acquired outside the context of a business acquisition.

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[71] This result is implicit in the treatment of partnerships under the legislative history. Conference Report, 686-687.

[72] Sec. 197(d) (1) (C) (iii).

[73] Sec. 197(e) (4) (C).

9. Interests in Land. The Conference Report states that the statutory exclusion for interests in land applies to a fee interest, life estate, remainder, easement, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, and any other similar rights with respect to land.[74] The regulations should confirm this point, and the exclusion should extend to temporal interests in any of these rights, which might not be literally covered under the exclusion for leases of tangible property. Also, Federal oil and gas leases should be covered by the exclusion even though they are also a form of government franchise. On the other hand, the regulations should provide that a nonexclusive right to use land is not an interest in land, consistent with the statement in the Conference Report that airport landing rights are not interests in land.[75]

10. Tax-Free Transaction Costs. Fees paid for professional services and other transaction costs incurred in a corporate organization or reorganization in which gain or loss is not recognized are not section 197 intangibles.[76] Thus, only corporate reorganizations are excluded. Guidance is needed for other types of transactions, such as partnership contributions and distributions, like-kind exchanges or taxable transactions. The Conference Report specifically disclaims any inference regarding these items.[77] The regulations should indicate whether section 197 or prior law applies to fees for these other types of transactions.

11. Certain Substituted Basis Transactions. Section

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[74] Conference Report, 679.

[75] Conference Report, 679.

[76] Sec. 197(e)(8).

[77] Conference Report, 683.

197 establishes a special basis rule for certain transactions between members of the same affiliated group and for certain nonrecognition transactions "described in section 332, 351, 361, 721, 731, 1031, or 1033."[78] In such transactions:

> the transferee shall be treated as the transferor for purposes of applying this section [197] with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.[79]

The Conference Report provides an example of this rule in the context of a like kind exchange under section 1031:

> assume that an individual owns an amortizable section 197 intangible that has been amortized under section 197 for [5] full years and has a remaining unamortized basis of $300,000. -In addition assume that the individual exchanges the asset and $100,000 for a like-kind amortizable section 197 intangible in a transaction to which section 1031 applies. Under the bill, $300,000 of the basis of the acquired amortizable section 197 intangible is to be amortized over the 10 years remaining in the original [15]-year amortization period for the transferred asset and the other $100,000 of basis is to be amortized over the [15]-year period specified in the bill.[80]

The Conference Report confirms that the statute was intended to apply to a transferor with a substituted basis in property under section 1031 or section 1033. The statute, on the other hand, literally applies only to a taxpayer with a carryover basis in property from another taxpayer (i.e., "the transferee shall be treated as the transferor"). The regulations should clarify that the rule in the statute applies to substituted basis transactions as illustrated by the Conference Report.

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[78] Sec. 197(f) (2) (B).

[79] Sec. 197(f) (2).

[80] Conference Report, 686.