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TAX TREATMENT ON INTANGIBLE ASSETS

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

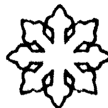
ONE HUNDRED SECOND CONGRESS

SECOND SESSION

ON

S. 1245, H.R. 3035, and H.R. 4210

APRIL 28, 1992



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TAX TREATMENT OF INTANGIBLE ASSETS

TUESDAY, APRIL 28, 1992

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:33 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Moynihan, Pryor, Daschle, Packwood, Danforth, Symms, and Grassley.

[The press release announcing the hearing follows:]

[Press Release No. H-16, April 9, 1992]

BENTSEN CALLS HEARING ON "INTANGIBLES," CHAIRMAN WANTS TO EXAMINE POSSIBLE SOLUTIONS

WASHINGTON, DC—Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, Thursday announced a hearing on simplifying the tax treatment of intangible assets acquired in business purchases.

The hearing will be at *9:30 a.m., Tuesday, April 28, 1992* in Room SD-215 of the Dirksen Senate Office Building.

Bentsen (D., Texas) said he wants to explore possible solutions to the controversy between taxpayers and the Internal Revenue Service regarding intangible assets.

"Under current law intangible assets—such as customer lists, technical know how and subscription lists—acquired when a business is purchased can be amortized only if certain conditions are met. These assets must have a limited useful life over which the value can be depreciated and they must be distinguishable from "good will," Bentsen said.

"A number of taxpayers consider current laws affecting intangibles to be unfair and confusing and require costly appraisals that could be avoided if the laws were simplified," Bentsen said.

"In considering this question, we want to take a close look at legislation that Congressman Rostenkowski has introduced and consider the potential impact of a case the Supreme Court has agreed to hear concerning the treatment of intangible assets."

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will come to order. The Internal Revenue Code allows taxpayers to amortize the cost of "wasting" assets over the useful lives of those assets. In the case of acquired intangible assets, there has been a great deal of controversy, legal costs and delays regarding the tax treatment of these assets—determining whether the intangible asset is a "wasting" asset, what the appropriate recovery period is, and so on.

Chairman Rostenkowski, on the House side, has introduced legislation to try to bring some reason to this area and to resolve the differing interpretations. He introduced H.R. 3035 in an attempt to

reduce those controversies and simplify the taxation of acquired intangibles.

The bill provides that the cost of goodwill and other acquired intangible assets would be amortized over a single 14-year period. A modified version of Mr. Rostenkowski's bill was included in the House version of the economic recovery tax bill, and, ultimately, in the conference agreement. However, we all know what happened to that tax bill: it was vetoed by the President.

When you try to resolve something like this by choosing an arbitrary line, such a 14-year period, you are obviously going to have winners and losers. We have learned in the Congress that we will soon hear from the losers. On the other hand, those that had over the 14-year period are quite pleased with what has been done.

Every group that thinks it has equity on its side in justifying a shorter recovery period is going to try to get an exception from the rule, and that is understandable. The problem we face in that regard is the cost. In a time of budgetary constraints, how do we take care of that? Do we change the yard stick? Do we make exceptions? And then how do we pay for them if we do?

The Chairman has had a rule in this committee to see that we pay for what comes out of the committee. And that has led to pain from time to time, and difficulty in getting a consensus.

I do not think what we have seen in the House legislation is the final word on the intangibles issue. And that is why I have called today's hearing. I want this committee to have the opportunity to explore the issues surrounding the tax treatment of acquired intangible assets, and, in doing so, to take a close look at the House intangibles bill.

I certainly applaud the goals of the House legislation in trying to simplify and reduce the controversies in this area. I am certainly an advocate of meaningful simplification. Yet, this is an exceedingly difficult area of the tax law. There are hard questions for which there are no clear cut answers.

So, I think it is important that this committee examine the pros and cons of this legislation. Fortunately, I believe we can do it with the excellent list of witnesses that we have testifying before us today.

Finally, in a recent development, the Supreme Court earlier this month agreed to review the Third Circuit's decision in the Newark Morning Ledger case to determine whether certain customer lists could be amortized for tax purposes or whether—as the Third Circuit decided—they should be treated as goodwill that cannot be amortized. I will be interested in hearing from the witnesses as to the potential impact of that case as well.

We are fortunate to have with us this morning Hon. Fred Goldberg, Jr., the Assistant Secretary for Tax Policy, Department of Treasury. And he is accompanied by Abraham N.M. Shashy. I do not want to mispronounce that name. Why don't you give it to me? Is it Shashy?

Mr. SHASHY. Shashy. Yes, sir.

The CHAIRMAN. All right. He is the Chief Counsel for the Internal Revenue Service. We are glad to have you back. Will you proceed with your testimony?

STATEMENT OF HON. FRED T. GOLDBERG, JR., ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, ACCOMPANIED BY ABRAHAM N.M. SHASHY, CHIEF COUNSEL, INTERNAL REVENUE SERVICE

Assistant Secretary GOLDBERG. Thank you, Mr. Chairman. It is a pleasure to be here today to present the views of the administration on proposals to amend the tax laws to provide certainty concerning the tax treatment of purchased intangible assets. I am accompanied by "Hap" Shashy, the Chief Counsel of the IRS.

Last October, Hap and I, together with my predecessor, Ken Gideon, provided administration testimony in support of H.R. 3035, a measure introduced by Chairman Rostenkowski to simplify the tax treatment of intangibles. A modified version of H.R. 3035 was included in H.R. 4210, as adopted by the Congress.

My statement today focuses on the differences between these two bills; a more extended discussion of the administration's views on the importance and parameters of intangibles legislation is contained in our prior testimonies, copies of which are being provided for the record.

Before turning to the specific differences between H.R. 3035 and H.R. 4210, I would like to offer a number of general observations.

Having seen the tax system now from a number of perspectives—as a practitioner, as Chief Counsel and Commissioner of the IRS, and as Assistant Secretary for Tax Policy—I regard the legislation concerning intangibles as the most important simplification measure under consideration by the Congress.

The current regime for taxing purchased intangibles results in substantial uncertainty and the unequal treatment of similarly situated taxpayers.

It imposes needless transaction costs and administrative costs on taxpayers and the government. It leads to frequent and expensive controversies between taxpayers and the IRS, and it deprives the Federal Government of substantial tax revenues that are properly due and owing.

No amount of after the fact enforcement and litigation can possibly remedy this situation. Legislation is essential if we are to eliminate this source of waste, inefficiency, and controversy.

I also want to emphasize my belief that the stakes go far beyond the issue at hand. The legislation you are considering is the product of more than 18 months of cooperation between the Congress, the administration, and the private sector.

In many respects, it is the centerpiece of our simplification efforts. It is not perfect, but there is no such thing as the perfect law.

On balance, it is fair and reasonable, it achieves its stated objectives, and is consistent with fundamental principles of sound tax policy. It is a dramatic improvement over the current state of affairs.

I believe it is the litmus test of our commitment and ability to achieve broad-based simplification of the substantive tax laws.

If legislation along the lines you are considering with such modifications you think are appropriate cannot be enacted, I see little hope for our ability to simplify elsewhere.

Finally, I want to reiterate two principles that have shaped the legislation you are considering. First, to avoid lengthening the re-

covery period and reduce to a minimum the complexity of allocating purchase price among intangible assets, we must strictly limit the classes of intangibles that are excluded from 14- year amortization. Second, the legislation must be essentially revenue-neutral.

The remainder of my testimony provides the administration's views on the primary changes to H.R. 3035, as reflected in H.R. 4210.

First, the modified or clarified treatment of computer software, mortgage servicing contracts, movies, and government-granted rights and licenses. And, second, provisions authorizing taxpayers to elect retroactive application of the statute.

In brief, we believe that the former changes are appropriate. They are minor modifications, largely clarifying in nature, and consistent with the intent and the structure of the original legislation. In contrast, certain aspects of elective retroactivity raise significant revenue and policy concerns.

Mr. Chairman, the remainder of my written statement discusses in some detail each of these changes. I would be happy to read through that statement, or conclude my opening remarks and turn to questions. I understand you are under some time pressure this morning, so I will proceed either way.

[The prepared statement of Assistant Secretary Goldberg appears in the appendix.]

The CHAIRMAN. Well, let us stop at that point, Mr. Secretary, and I will pursue some questions. Let me get a further clarification of what you have stated here.

Where you say, "First, to avoid lengthening the recovery period and reduce to a minimum the complexity of allocating purchase price among intangible assets, we must strictly limit the classes of intangibles that are excluded from 14-year amortization. Second, the legislation must be essentially revenue-neutral."

That, in effect, is what I said in my opening statement.

Assistant Secretary GOLDBERG. Yes, sir.

The CHAIRMAN. And I share that very strongly with you. But let me get further clarification of your addendum here. When you say, "In brief, we believe that the former changes are appropriate—they are minor modifications"—are you talking about changes on computer software, mortgage servicing contracts, movies, and government-granted rights, those things were modified in the legislation?

Assistant Secretary GOLDBERG. Yes. They were different. They were changes between H.R. 3035 and H.R. 4210.

The CHAIRMAN. Right.

Assistant Secretary GOLDBERG. I think in each instance, for example, software is consistent now with the treatment of other intellectual property, such as patents and copyrights.

The CHAIRMAN. Yes. Mortgage servicing—one of my subsidiary companies when I was in the private sector did mortgage servicing. And the ten year life of those is something I know to be a fact. So, you support that kind of thing.

Assistant Secretary GOLDBERG. Yes, sir. And what H.R. 4210 does is clarify that the debt portion of those arrangements should be treated as debt and written off over whatever the life of what those debt obligations are, whether it is 5 years, or 25 years.

And we think that those instruments are in the nature of debt, should be treated in that fashion, and that, in many respects, it simply clarifies what was intended all along.

The CHAIRMAN. Well, let me ask you. Was that piece of legislation revenue-neutral, as it was modified?

Assistant Secretary GOLDBERG. The legislation in 4210, in our view today, is that it was not revenue-neutral. The reason for that is——

The CHAIRMAN. I am sure you are pleased, then, to tell us how to pay for it.

Assistant Secretary GOLDBERG. We would suggest modifications to that statute that would make it revenue-neutral.

The CHAIRMAN. Such as?

Assistant Secretary GOLDBERG. Eliminating the elective retroactivity feature.

The CHAIRMAN. Would that make it revenue neutral?

Assistant Secretary GOLDBERG. Yes, sir. It would.

The CHAIRMAN. I have a number here given to me by the Joint Tax Committee. They say that the retroactivity portion will lose $3.2 billion over that 5-year window. Are you in concurrence with that estimate?

Assistant Secretary GOLDBERG. We have not completed our review, but we believe that the revenue loss is quite substantial and does measure in the billions of dollars. Yes, sir.

The CHAIRMAN. Can you give me anything more definitive than billions of dollars?

Assistant Secretary GOLDBERG. We are trying to refine that. The difficulty here is that you are not dealing with a lot of transactions, you are dealing with a relatively limited number of very large transactions.

The Internal Revenue Service is reviewing those and trying to test what would be the implications of elective retroactivity. We have not completed that process yet, but it is clear that it would be quite expensive.

Because the retroactivity is elective, it occurs to us a taxpayer is only going to elect that result if it benefits them.

The CHAIRMAN. Of course.

Assistant Secretary GOLDBERG. And it is sort of difficult to envision how that regime can truly be revenue neutral.

The CHAIRMAN. Yes. Now, we have got some technicalities here we are trying to resolve. Let me ask you, Mr. Shashy.

Mr. SHASHY. Yes, sir.

The CHAIRMAN. On these questions of retroactivity, what sort of approach would you take in these pending cases to which the legislation would not apply in the absence of a retroactive election?

Mr. SHASHY. It has been our experience that when legislation passes that is not legally applicable to pending cases, it nonetheless has a practical effect on the behavior of the parties.

What we would propose to do, what we have advocated from the start with respect to this legislation is simply to be able to resolve those cases in the normal course.

We are confident, frankly, that they will by and large settle, and that fewer of them will be litigated than would be litigated if this legislation did not pass. That was our experience.

Anecdotally, when ACRS was enacted in 1981, also when some of the anti-straddle legislation was enacted in 1981, and we believe it would be the case here.

In order to ensure that, we would be willing to attempt to engineer and implement a coordinated settlement program of some sort—we do not have the details of that in mind—but if the legislation were to pass prospectively, we would be willing to do that in an attempt to resolve pending cases short of litigation.

The CHAIRMAN. Secretary Goldberg, would you comment on what you think the revenue effect would be outside of the budget period, outside of 5 years?

Assistant Secretary GOLDBERG. What we attempted to do, working with Congress and the Joint Committee in developing the original legislation, 3035, was to assure that—to pick a period, namely, 14 years, it would be revenue neutral over the long term.

We have certain budget conventions that we use, but when you are making a change of this sort, you do not want to solve your problems in a 7-year window and then leave yourself with a mess in the out years.

So, in setting the 14-year period, we believe that that would be essentially revenue neutral over the long term.

The difficulty with the elective retroactivity feature is the way that it is structured it builds a problem outside the budget window so that whatever the number is during the pay-go or budget agreement scoring period, the number would be much larger over the full 17-year period cycle.

So, that is one of the reasons that we were troubled with retroactivity, and it was one of the factors we tried to keep in mind in the base legislation.

The CHAIRMAN. Well, let me get to another one. The General Accounting Office chose a different approach to this, as I understand. They chose, on the intangibles, to establish various classes with different recovery periods, thus perhaps not having as much of a disparity in the winners and losers.

What do you think of that kind of an approach, assigning different recovery periods to different classes, as is sometimes done, I guess, on the tangibles?

Assistant Secretary GOLDBERG. In our judgment, that would be an exceedingly difficult step to take because the nature of intangibles is that, unlike tangible assets, they are hard to define to begin with.

Secondly, they are very difficult to value. And if you were to create separate classes of intangible assets, you would find yourself, we believe, in continued controversies over how those definitions applied and how the subject assets were valued. And we think that, on balance, a single life is the preferred regime. We think it is the most administrable.

While we are prone to refer to winners and losers, it is at least my judgment that the winners are unlikely to win as much as they think they might, and the losers are unlikely to lose as much as they are afraid.

And I think that the nature of goodwill or intangibles is they do center around a 14-year period. And I think that is acceptable.

The CHAIRMAN. But you would not have as much disparity, would you, between the extremes on the winners and the extremes on the losers.

Assistant Secretary GOLDBERG. I think what you are trying to balance is, can you minimize those disparities——

The CHAIRMAN. That is right.

Assistant Secretary GOLDBERG [continuing]. In which you are trading off minimizing those disparities against the continuing uncertainty and controversy that has been created.

The CHAIRMAN. But you think the multiplicity of determinations in getting to the various ones in between leads to more problems?

Assistant Secretary GOLDBERG. Yes. Yes. Yes, I do.

The CHAIRMAN. Well, let us get to high technology assets, such as silicon chip designs and aircraft engine designs, and covenants not to compete. How do you feel about exceptions for them?

Assistant Secretary GOLDBERG. Well, with respect to the high-tech intangibles, first, I think it is important that we sort of step back and look at the regime.

You have a pre-existing regime for patents and copyrights so that to the extent the intangibles are embodied in that proprietary format, you are under a set of rules that you have been under for a long period of time.

And they are carved out for that reason, in the case of freestanding rights. With respect to other types of high-tech intangibles, to the extent they are licensed with periodic license payments, those periodic license payments are deducted as incurred.

If you are talking about the so-called high-tech intangibles in the context of the acquisition of a business, it is at least my judgment that, as the Internal Revenue Service turns its attention to those transactions, high technology companies are likely to find themselves, in many circumstances, benefitted rather than harmed by the 14-year life, because most of the value in high-technology companies can be associated with work force, can be associated with the unidentifiable goodwill going to the fact that these folks know what they are doing and they have the experience.

And I think by the time the service completes its examination efforts in those areas, a number of these companies might find that they would prefer the 14-year result.

Now, with respect to covenants not to compete, our understanding of the existing statute is that if it is a freestanding covenant not to compete, I simply contract with an individual not to compete with me in my location, that is in the nature of provision of services and is governed separately.

If you were talking about covenants not to compete in the context of an acquisition of a business, it is the Service's experience, it is our experience, that is one of the most common areas of controversy. Values more properly attributable to goodwill and unamortizeable assets are shifted to covenants and that is exactly the kind of arrangement that should be treated through a composite 14-year life. And I believe that is a far better treatment.

The CHAIRMAN. Well, now, the Supreme Court is saying they are ready to review the Newark Morning Ledger case. And, as I recall, that held that customer lists were not subject to amortization because they are so entwined with goodwill, in effect.

Now, that could affect substantially, I suppose, the revenue that the government receives, depending on how the Court decides. Do you think there would be reason to wait until the Court makes its decision?

Assistant Secretary GOLDBERG. No, Mr. Chairman. I do not. And I do not for two reasons. First, as I said in my statement, I personally am convinced that no amount of legislation, no court decisions, whether it is the Supreme Court or lower courts during the process, can ever hope to provide the kind of clarity and certainty that taxpayers need on an ongoing basis.

If the Supreme Court were to adopt the government's position that, as a matter of law, customer lists are intertwined with goodwill and cannot be amortized, I think you will still find that there are an unlimited number of controversies in this area.

What used to be ascribed to value of customer lists might be ascribed to covenants not to compete; might be ascribed to work force in place; might be ascribed to other so-called intangibles.

So, I have no confidence that whatever the decision is, it will provide the requisite degree of certainty.

Secondly, I believe that this law is critically important to providing the kind of simplification we are all committed to And since the proper way to resolve the matter is through the legislative process, I would hope we could get about our business and get it done, and that we should not be unduly influenced by whatever the revenue implications are of that decision.

The CHAIRMAN. Let me take you back to the retroactivity provision for a minute. One of the things that concerns me a bit is that the provision was not in effect at a time that the deal is made, was not taken into consideration, and all of a sudden, it is there. Is that, in effect, a windfall for some of these companies?

Assistant Secretary GOLDBERG. It is a windfall. I mean, in a situation, particularly prior to repeal of General Utilities, a purchaser who elected purchase accounting for tax purposes and carried goodwill on its books does receive a windfall.

The ability to write off that goodwill becomes enormously beneficial. So, in that sense, it is a windfall. It is also troublesome because the entire benefit of that treatment goes to the purchasers and none of that benefit goes to the sellers.

So, in a leveraged buy-out transaction, for example, where public shareholders sold their shares not knowing this was on the books, the entire benefit of that tax treatment would go the purchasers. None of that benefit of retroactivity would go the public selling shareholders.

So, yes. It is a windfall, and it is a windfall solely to the purchaser and none of it to the sellers.

Mr. SHASHY. If I might add, Mr. Chairman, there are other aspects of unfairness to the elective retroactivity. For example, the open-year election would largely be a matter of fortuity. Most taxpayers who have significant open years are large corporate taxpayers.

And among them there is great disparity to the extent to which prior years are open. It depends on the currency of our audit process. And, so, that is another potential aspect of disparate or unfair treatment.

And, also, given that refunds that would result from an open-year election would not bear interest, you could end up in a situation where compliant taxpayers who essentially minimize amortization in earlier years and pay greater tax would be in the position of having made interest-free loans to the government while more aggressive taxpayers would have had the use of the money over time. So, for those reasons additionally, we think it is a bad idea.

Assistant Secretary GOLDBERG. Mr. Chairman, I want to be clear that we share Congress' concern that the image of the government and taxpayers litigating for years to come over issues that have no ongoing significance is very troublesome. And we would hope that the system could find a way to resolve those controversies promptly and expeditiously.

I think the Chief Counsel's suggestion that uniform settlement guidelines would assure uniformity and could be structured in a way to encourage prompt settlement, is the best way to go to avoid that morass. And, with continued Congressional oversight, it is likely that many of those cases could be put behind all of us in the relatively near future.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I am reminded of an old saying: the question is very much too deep, much too wide, and much too hollow, and learned men on either side use arguments I cannot follow. [Laughter.]

Thank you, Mr. Chairman.

The CHAIRMAN. Well, we have finally probed your depths on one subject. [Laughter.]

Gentlemen, thank you very much.

Assistant Secretary GOLDBERG. Thank you.

The CHAIRMAN. Our next panel will consist of Mr. Peter Faber, who is chairman, Tax Section, American Bar Association; Mr. Leonard Podolin, who is the chairman, Tax Executive Committee, American Institute of CPA's; Mr. Willie Baker, international vice president and director, Public Affairs Department, United Food and Commercial Workers International Union; Mr. Floyd Williams, chief tax counsel, for the Tax Foundation; Duane Suess, who is vice president of Taxes, International Multifoods Corp., on behalf of the Coalition for Open-Year Election; Mr. Kenneth Kies, counsel for Amortization of Intangibles Task Force, Washington, DC. Anyone's name I have mispronounced is now free to correct it.

Mr. SUESS. Suess rather than Suess.

Mr. PODOLIN. Podolin.

The CHAIRMAN. Podolin. Thank you very much. Mr. Faber, chairman of the tax section of the American Bar Association, we are pleased to have you. Would you proceed?

STATEMENT OF PETER L. FABER, CHAIRMAN, TAX SECTION, AMERICAN BAR ASSOCIATION, WASHINGTON, DC, ACCOMPANIED BY DAVID GLICKMAN, CHAIRMAN OF THE TASK FORCE ON INTANGIBLES, AMERICAN BAR ASSOCIATION

Mr. FABER. Mr. Chairman, my name is Peter Faber, chair of the American Bar tax section. I am accompanied by David Glickman, the chair of our Task Force on Intangibles.

I first testified before this committee urging simplification of the tax laws in 1976, and it was a dismal failure. We have clearly gone backwards since then.

I now appear before you to support what, in my view, is a major simplification effort. We recognize that in any effort to simplify the tax laws, there has to be a trade-off. Whenever you simplify, you lose something in terms of equity and fairness. There has to be a balancing process.

But we conclude that this is an area where, in that balancing process, simplification wins hands down. The intangible provisions of H.R. 4210 represent an idea whose time came 20 years ago, but no one knew it. And we support its approach enthusiastically.

I cannot tell you how many times I have sat in conference rooms in the following scenario: we have a client who is buying a business; they are paying, let us say, $150 million for it.

You know that the tangible assets are worth $90 million, and you also know that there are intangible assets all over the place. There are service contracts, favorable leases, an experienced work force, a customer list, and there is goodwill.

They all have value, but you do not know how much. And there is a tremendous temptation to tilt the allocation of your purchase price in favor of those intangibles that will do you the most good—those that are amortizable.

This kind of game-playing has no place in a rational tax system. And, Mr. Chairman, this is exactly the way it happens. I know; I have been in that conference room many times. The bill would eliminate it.

Now, one might say that the bill will add language to the Internal Revenue Code, and how can that be a simplification? But, in fact, it would result in substantial transactional simplification. It would eliminate a lot of complex tax planning; it would eliminate a lot of fights between my clients and Hap Shashy's people at the IRS.

I give a lot of speeches on the taxation of mergers and acquisitions; I am giving one on Monday. I have a 104-page outline on the subject. If this bill were passed, I could lop off 18 pages from that outline, and that has got to be an improvement in the world.

Now, the Supreme Court has, as you noted, granted certiorari in the Newark Morning Ledger case. That may well clarify some of the issues that we are concerned with, but it will not clarify all of them. In our view, meaningful simplification will not be achieved unless there is legislation.

Now, let me turn to some of the policy issues. We strongly support a single amortization period. We recognize that this will mean that some assets will be amortized over a shorter period or a longer period than their economic useful life. But the need for simplicity outweighs any disadvantage of the resulting distortion.

We would urge, however, that the bill be confined to purchases of an ongoing business. The bill generally applies, with some exceptions, to purchases of all intangibles, even if not acquired as part of an ongoing business. We think that is unduly broad.

There is some distortion, as I pointed out, whenever you have a single amortization period. The need for simplification arises primarily in the purchase of an ongoing business where you have allo-

cation questions. The complexity results from the need to allocate and the IRS's problems in enforcing reasonable allocations.

If you simply buy a single intangible, there is no allocation problem and, in our view, there is no reason why you should impose an amortizable period that is different from the actual, useful life.

Now, again, we recognize that there is a possibility of distortion in many of these areas. But we think it would be workable to confine the scope of the bill to purchases of businesses, as, indeed, it is with respect to many assets, and that that would be a fair balancing of the need for simplification in some areas versus the desire for equity.

Now, let me turn, in closing, to the retroactivity issue, Mr. Chairman. This is a very difficult one, and we are very troubled by it. The section generally opposes retroactive tax legislation. Obviously, we are also in favor of eliminating costly litigation.

The approach of H.R. 4210 to retroactivity is a novel one, offering taxpayers an election to apply the provisions retroactively at the cost of a 17-year amortization period.

We are very troubled by the retroactivity provisions, Mr. Chairman. It can lead to unfairness in cases where companies have open years. They are benefited by it and they can make the election. Companies that have closed their prior years cannot make the election.

We believe that, in many cases, the beneficiaries of this election would be your very large corporations that are audited continuously and may have 10-12 years that are open, whereas small companies are more likely to have very few open years.

We are also troubled by the revenue effect of allowing large companies a retroactive election. We do not take a position for or against the retroactivity provision, but we are very concerned about it and we urge that the committee tread very cautiously in this area. Thank you.

[The prepared statement of Mr. Faber appears in the appendix.]

The CHAIRMAN. Pretty gutsy. [Laughter.]

All right. The problem is, we have to make a decision. Mr. Podolin, if you would proceed.

STATEMENT OF LEONARD PODOLIN, CHAIRMAN, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC, ACCOMPANIED BY LORIN LUCHS, CHAIRMAN OF SPECIAL TASK FORCE ON AMORTIZATION OF INTANGIBLES, WASHINGTON, DC

Mr. PODOLIN. Thank you, Mr. Chairman, for this invitation to testify today on behalf of the American Institute of Certified Public Accountants and our over 300,000 members.

I am Leonard Podolin, chairman of the Tax Executive Committee of the AICPA. And with me, on my left, is Lorin Luchs, chairman of our special task force that we formed several years ago to study the issues of amortization of intangible assets.

The AICPA supports legislation to allow amortization of intangible assets mainly on the basis that it will simplify the tax law and reduce controversies.

We support this legislation, recognizing that it will reduce the need for appraisal and valuation services that are often performed by CPA's.

It is our position that most, if not all, intangibles can indeed be valued, and that their useful lives are reasonably determinable.

However, the constant and ongoing disputes about these values and lives are unproductive, and we believe that standardizing rules will eliminate or reduce these disputes.

The recent grant of certiorari by the U.S. Supreme Court in the Newark Morning Ledger case involving subscription lists and the very recent taxpayer victory in the Jefferson Pilot case that involved FCC broadcast licenses, are just two recent examples of these types of disputes.

Legislation of this type can reduce controversies, while still maintaining equity among various industries by providing different amortization lives for all, or categories of, intangibles in specific industry groups, similar, let us say, to the depreciation rules for tangible assets.

Differentiating a software company from, let us say, a heavy equipment manufacturer, or an airline company, or a bank, or a broadcasting company, does not seem to us to be likely to create controversies.

However, if an across-the-board single life of, let us say, the 14 years that is proposed is what it takes to simplify the law, we support it.

We do, however, believe that a good deal of the benefit of the proposal is lost if it is still necessary to calculate gains or losses when some, but not all, of the intangibles acquired in a business purchase are disposed of.

Therefore, we urge a change in the legislation to provide that gains as well as losses be deferred.

On elective retroactivity, we support it as a vehicle to resolve pending or potential disputes. However, as we have stated on a number of other occasions, we believe it is bad tax policy not to pay interest on refunds, and we urge you to reconsider this particular aspect of the legislation.

Nevertheless, if you do not change this provision on interest on refunds, we would continue to support the bill on the basis that it is necessary to achieve the level of reduction in disputes that will occur by permitting elective retroactivity.

In summary, the AICPA supports the enactment of the proposed amortization of intangibles legislation. We believe this legislation, properly drafted, will alleviate most of the need to separately evaluate identifiable intangible assets acquired as part of a continuing business, and it will thereby facilitate business acquisitions and reduce costly disputes between taxpayers and the IRS.

We urge that the legislation be properly drafted to meet these intended purposes of simplification. Thank you.

[The prepared statement of Mr. Podolin appears in the appendix.]

The CHAIRMAN. Mr. Baker, if you would proceed.

STATEMENT OF WILLIE L. BAKER, JR., INTERNATIONAL VICE PRESIDENT AND DIRECTOR, PUBLIC AFFAIRS DEPARTMENT, THE UNITED FOOD AND COMMERCIAL WORKERS INTERNATIONAL UNION, WASHINGTON, DC, ACCOMPANIED BY LESLIE NULTY, ECONOMIST, THE UNITED FOOD AND COMMERCIAL WORKERS INTERNATIONAL UNION

Mr. BAKER. Good morning, Mr. Chairman. My name is Willie Baker. I am international vice president with United Food and Commercial Workers Union and director of our public affairs department. On my right is Leslie Nulty, our economist for our department.

I want to certainly give our appreciation for you having these hearings today. A more complete text of my statement will be prepared and given to you.

We believe that the tax issue at hand, the amortization of intangible assets, is intimately related to corporate takeovers, acquisitions, and divesture behavior.

Over the past decade, this activity has caused enormous pain and suffering for hundreds of thousands of UFCW members.

H.R. 3035, a modified version of which was included in the Senate/House tax bill vetoed by the President earlier this year, allows the amortization of goodwill and going concern value, along with virtually any and all intangible assets a company can claim.

This, we believe, would introduce a tax subsidy to takeovers that did not exist in the 1980's. We in the UFCW are particularly sensitive to this because roughly 75 percent of our 1.2 million workers that we represent in this country work in three sectors that were hotbeds of takeover/leveraged buy-out mania of the 1980's: supermarkets, department stores, and food processing.

As a result of that activity and its continuing aftermath, the single largest employer of UFCW members is an investment banking firm, Kholberg, Kravis, & Roberts. We presently represent over 130,000 members at various acquisitions of that firm.

Through other leveraged buyouts and through defensive restructuring by firms being attacked by corporate raiders, tens of thousands of our members lost their jobs outright.

When Grand Union was taken private and LBO, its Colonial/Big Star division in the Carolinas was sold; 3,000 UFSCW represented workers lost their jobs.

When Lucky Stores restructured itself to escape a hostile takeover by Asher Edelman, the company first sold its Gemco division; 5,000 UFCW members lost their jobs there. Another 2,000 took substantial cuts when Lucky's spun-off its Eagle Food Stores division.

The various parts of the former Armour Co. and Beatrice Foods have been through so many ownership changes over the past 10 years, with accompanying buying and selling of plants, it is almost impossible for us to keep track of the number of jobs that have been lost.

While some of the LBO deals of the 1980's are back on the road to financial and operating health, others are mired in bankruptcy and near bankruptcy and their employees constantly face demands for additional cuts in pay and benefits.

In looking at this morning's paper, I notice that the chief of Macy's has decided to retire because of the debt load that he has put on his company.

Let me just read you one little sentence from that. "In the industry where he was widely considered to be one of the last Prince Merchants, many said the move was sad, but inevitable, after he loaded down his chain with billions of dollars in takeover debt."

Knowledgeable Wall Street observers also believe that the industry in which our members work, retail food, will be the center of the next round of takeovers and divesture activity that will be fueled by this legislation. To us, that spells even more pain and suffering.

As it is currently written, H.R. 3035 is an abandonment of the principles of equity and progressivity of the Tax Reform Act of 1986. It did so much to restore our tax system.

It rewards those who have done most to weaken the U.S. economy, it sends the wrong message to corporate America regarding what kind of economic behaviors are most desirable.

This bill will transfer income from U.S. Treasury to tax avoiders that have substantial interest in seeing this legislation passed. It is argued that something needs to be done to end the litigation, and this may be so.

But where did the litigation come from? To us, it looks as though the same people who put together those questionable deals also exploited and widened every loophole they could find and/or create in the existing body of tax law.

They have created a mountain of litigation in an attempt to force rulings in their favor, if not by the IRS, then by the courts. And if not by the courts, then by Congress.

It is said that this legislation is revenue neutral. A $200 million loss is estimated over 5 years. Where we come from, $200 million is not considered revenue neutral, and I am sure that most American taxpayers would not consider that to be revenue neutral.

The legislation that Congress writes must limit the Internal Revenue Service's ability to make discretionary rulings in this area.

Its language must put an end to the clever reallocation of goodwill and ongoing concern value over a limitless range of investment assets. If this is accomplished, tax consideration will play less of a role in takeover and acquisition decisions.

Mr. Chairman, the tax law reflects the values of our Nation. We give tax incentives for people who buy homes because of mortgage deductions, and other things like that. This legislation does none of that.

I would like to thank you for your attention. Myself and my assistant, Leslie Nulty, who is the Economist for our department, would be glad to answer any questions at the end of the process. Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Baker appears in the appendix.]

The CHAIRMAN. Mr. Floyd Williams, the chief tax counsel for the Tax Foundation. Mr. Williams, we are happy to have you.

STATEMENT OF FLOYD L. WILLIAMS, CHIEF TAX COUNSEL, TAX FOUNDATION, WASHINGTON, DC

Mr. WILLIAMS. Mr. Chairman, members of the committee, my name is Floyd Williams. I am chief tax counsel for the Tax Foundation. We are a non-profit, non-partisan research and education organization that has been monitoring tax and fiscal policy since 1937.

We have about 600 members consisting of large and small corporations, charitable foundations, and individuals. Our business membership encompasses practically every industry category.

It is an honor for me to be here today to present testimony on the issue of simplifying the tax treatment of intangible assets acquired in connection with the purchase of a business.

This is a complex issue, and it has generated numerous controversies between taxpayers and the IRS. I do not appear here today on behalf of any particular industry group; rather, I am here to promote what we believe is sound Federal tax policy.

The current law tax treatment of purchased intangible assets, as you have heard already, if left unchanged, will continue to be a source of significant controversy between taxpayers and the IRS.

These controversies generally concern three types of questions. One, whether an intangible asset, in fact, exists; if so, the portion of the purchase price of a business that is allocable to intangible assets; and, finally, the proper methods and periods for recovering the costs of these assets.

The facts and circumstances nature of these controversies continues to lead to costly disputes between taxpayers and the Internal Revenue Service. These often result in different treatment of like-situated taxpayers.

The disparity between the tax treatment of goodwill, which cannot be amortized, and other intangible assets that are amortizable, provides incentives for taxpayers to establish values and lives for purchased intangible assets other than goodwill.

This leads to further disputes between taxpayers and the IRS that could be eliminated if goodwill could be amortized under the law.

Enactment of legislation like that contained in H.R. 4210 to allow an amortization deduction for the cost of intangible property, including goodwill and going concern value that is acquired in the purchase of a business, would have a salutary effect, we believe, upon the tax law.

In short, many of the controversies in present law could be eliminated through the application of a single method and period for recovering the cost of most acquired intangible assets, and, further, by treating acquired goodwill and going concern value as amortizable, rather than non-amortizable, assets.

This would be a significant step toward meeting the goal of proper and consistent administration of our Nation's tax laws and would eliminate the continuing uncertainty and uneven treatment of taxpayers that exist in this area of the law.

Quite significantly, enactment of legislation like that contained in H.R. 4210 would eliminate most of the costs that are currently being borne by taxpayers and the government to resolve controver-

sies over the proper tax treatment of purchased intangible assets. These costs could then be devoted to more productive endeavors.

Moreover, those taxpayers who currently cannot afford the costs of pursuing a controversy through the IRS administrative process, or challenging the IRS in the courts, would be treated much more fairly.

Finally, I would like to point out, by simplifying the tax treatment of intangible assets acquired in business purchases, that Congress would be recognizing one of the major principles of the tax foundation, which is that the tax law should be as simple as possible.

Present law in this area serves as a graphic example of how complexity can make accurate tax compliance needlessly expensive and punitive. This is an area of the law where meaningful simplification is within reach.

Although, as with any tax legislation, there would be winners and losers, in this case, most taxpayers would welcome the certainty and the reduction in IRS audit and legal costs that would flow for major simplification.

This concludes my statement. I would be pleased to answer any questions after the panel has concluded. Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Williams appears in the appendix.]

The CHAIRMAN. Mr. Duane Suess, vice president, Taxes, International Multifoods Corp., on behalf of the Coalition for Open-Year Election.

Mr. Suess.

STATEMENT OF DUANE A. SUESS, VICE PRESIDENT, TAXES, INTERNATIONAL MULTIFOODS CORP., MINNEAPOLIS, MN, ON BEHALF OF THE COALITION FOR OPEN-YEAR ELECTION

Mr. SUESS. Good morning. My name is Duane Suess. I manage the tax department for the International Multifoods Corp., headquartered in Minneapolis, MN, with operations throughout the United States.

Multifoods is primarily engaged in the manufacture and distribution of food products for restaurants, schools, delis, and the like. I am appearing today on behalf of a group of companies who are strongly in favor of the intangibles legislation, particularly the open-year election.

The group that I am representing is a broad-based group of companies, covering all sectors of the economy from all regions of the country. Large companies and small companies are represented in our group.

There are two attributes that we all share. First of all, we are all strongly in support of the intangibles legislation, as it was included in H.R. 4210, which is the bill that was passed by Congress last month, but vetoed by the President.

Secondly, we are all strongly in favor of the open-year election that was provided in that bill, and that provided for a 17-year life for previously acquired intangibles.

There are three reasons for our strong support. First of all, we believe current law is unclear, and, therefore, inequitable. Taxpayers with similar facts are treated differently.

Second, the government and taxpayer resources are being wasted in a controversy with no clear answer. And, finally, the intangibles legislation, we believe, is simple, fair, and economically efficient.

Now, I would like to share with you Multifoods' situation and why we are involved in this process. First of all, over the past 8 years, Multifoods has acquired some 30 companies. About two-thirds of our acquisitions involved the acquisition of intangible assets which would be covered by this legislation.

All of our acquisitions were friendly. We were involved in no hostile takeovers, no leveraged buyouts. We made all of these acquisitions with the intent of growing and making these companies prosper.

We took what we believe to be conservative positions on our tax returns. And, yet, upon examination, the IRS has contested 100 percent of every intangible asset.

And, for us, the intangible assets for which we claimed benefits were in three primary areas: computer software, non-compete covenants, and customer lists. We are confident of the position we claimed on our tax returns, and we intend to vigorously defend that position.

Making the election under H.R. 4210, for us, would result in an immediate cost in excess of $10 million, and over the 17-year life provided in that bill, it would result in a cost in excess of $2 million.

In spite of this extensive cost, it is highly likely that we would make this election if we were given the opportunity to do so.

And we would make the election for three reasons. It would give, for us, an immediate certainty in this area and close the controversy that we currently have with the IRS.

Secondly, we would benefit from a substantial savings in litigation costs. We would save attorneys' fees, accountants' fees, and appraisal fees.

And, finally, it would allow us to redirect our management time and resources to operating our company, which is really what we are in business to do.

This legislation is good tax policy. However, to provide immediate and meaningful simplification, the legislation must apply to previously acquired intangibles.

Currently, there are numerous controversies in the open years and it will take years to work through the system in the absence of an open-year election with costly, inconsistent, and inequitable results.

Likewise, we are convinced that allowing the IRS to use the legislation as a guideline for resolving prior cases will still result in costly, inequitable, and inconsistent results.

Taxpayers would not be on a level playing field. There would be no significant savings in either taxpayer or IRS resources for years to come, and cases would continue to clog the courts with no precedential value.

Based upon the estimates by the staff, the 17-year life that was provided in H.R. 4210 was designed to be revenue neutral. There-

fore, if that is true, without an open-year election, government and taxpayer resources would continue to be wasted with no net revenue impact for the government.

In summary, we are here today because we believe this legislation is good for the government and good for our companies.

And we see the benefit in three parts: certainty, a reduction in litigation costs, and, finally, it would allow us to redirect management time and resources to expanding operations, developing new products, and, most importantly, creating new jobs.

Thank you for this opportunity to address this important issue.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Suess appears in the appendix.]

The CHAIRMAN. Mr. Kenneth Kies, who is counsel for the Amortization of Intangibles Task Force.

Mr. Kies.

STATEMENT OF KENNETH J. KIES, COUNSEL, AMORTIZATION OF INTANGIBLES TASK FORCE, WASHINGTON, DC

Mr. KIES. Thank you, Mr. Chairman. I am a partner with the law firm of Baker & Hostetler. I am here in my capacity as counsel to the Amortization of Intangibles Task Force.

The Task Force consists of industry, trade associations, and corporations representing almost 500,000 insurance agents throughout the United States.

Its members include: the Independent Insurance Agents of America; the National Association of Insurance Brokers; the National Association of Casualty and Surety Agents; and the National Association of Professional Insurance Agents.

The Task Force supports enactment of S. 1245, the Amortization of Intangibles Clarification Act of 1991, originally introduced by Senators Daschle and Symms, and currently co-sponsored by 19 Senators, including 5 members of this committee.

S. 1245 would clarify existing law for all open tax years in a manner consistent with many judicial decisions in this area, the reasonable expectations of most taxpayers who acquired these assets, and the decision of this committee in 1987 to reject legislation which would have eliminated amortization of customer-based intangibles. Similar legislation is pending in the House, with 188 cosponsors.

The task force, alternatively, also supports enactment of Section 4501 of H.R. 4210, Chairman Rostenkowski's legislative proposal to simplify the tax treatment of intangible assets. It would achieve a significant simplification for many of the reasons discussed by other witnesses.

It is important, however, to emphasize that our industry would be a loser under this bill. Notwithstanding, the industry supports it, because it would bring simplification, eliminate the cost of valuation experts, eliminate the cost of tax lawyers, and make it possible for people to spend more time running their businesses and less time fighting with the Internal Revenue Service.

Most of our taxpayers currently amortize their assets over a 5 to 7-year period. Fourteen years would be a substantial change for them, even with goodwill.

The Task Force also supports the clarification of prior law. We believe that taxpayers, if they can demonstrate that they actually valued the asset correctly and determined the correct useful life, should be entitled to amortize these assets.

We believe this expectation, at the time these assets were acquired, was reasonable, and we believe that the IRS's coordinated issue paper which has been issued retroactively jeopardizes the ability of taxpayers to amortize these assets, even though they have been able to demonstrate the fair market value and useful life.

We believe that the expectation which taxpayers had, that they would be able to amortize these assets if they could demonstrate fair market value and useful life, was reasonable for a number of reasons.

First, the historic tax policy explanation for prohibiting amortization of goodwill is that it has an indeterminate useful life. If a taxpayer can demonstrate useful life, it would seem that that is inconsistent with the historic tax policy reason for prohibiting amortization of goodwill.

In most cases, insurance agencies can demonstrate the useful life of insurance expirations—e.g., customer lists—that they have acquired.

Second, permitting amortization of intangible assets with fair market value and useful lives is consistent with the basic net income method of calculating taxable income. If you prohibit taxpayers from amortizing a wasting intangible asset, you are, in effect, taxing them on their gross income.

Third, many judicially-decided controversies involving taxpayers were resolved by permitting amortization of customer-based intangibles over their useful lives. Taxpayers reasonably anticipated if they could demonstrate useful life and fair market value they would be entitled to that recovery.

Finally, representatives of the IRS, the Treasury Department, and the Justice Department all concede, at a minimum, that the state of the law in this area is thoroughly confused.

For example, the Solicitor General, in filing the brief in the Newark Morning Ledger case, even though they supported the Third Circuit decision, did not oppose the petition for writ of cert by the taxpayer by concluding that this was an issue of substantial administrative importance that has given rise to inconsistent reasoning and inconsistent decisions among the circuits. In other words, the Solicitor General was saying no one knows what the current state of the law is.

We think it is abundantly clear that there is a crying need to provide a legislative solution to the substantial number of controversies that are currently pending between the IRS and taxpayers, in light of the state of confusion as to existing law.

It is difficult for us to understand how anyone can characterize such a clarification of law, such as that that has been proposed by Senators Daschle, Symms, and other members of this committee, as retroactive legislation, when it is merely an attempt to try to give to taxpayers what they reasonably anticipated they were entitled to at the time they acquired these assets.

Senator Daschle's legislation, if applied to prior controversies, would provide that taxpayers are entitled to recover the cost of intangibles if they can demonstrate useful life and fair market value, and we think that that is a reasonable approach to solving the existing glut of cases. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Kies appears in the appendix.]

The CHAIRMAN. Mr. Suess, within your coalition, the corporations you represent, what would be the size of the largest of the refunds that one of these corporations would receive as a result of a retroactive election?

Mr. SUESS. Mr. Chairman, I am not aware of the specific circumstances of any other company other than my own. So, I can really only address that, in our case, it would be a cost. I imagine there would be some winners, and there would be some who would have a cost incurred, but I am not sure of the specifics.

The CHAIRMAN. Well, if one of the reasons that you have for endorsing a retroactivity election is to end the greatest amount of controversy, then why would you not make it mandatory?

Mr. SUESS. I believe that mandatory legislation is a very frightening thought, if it is mandatory and retroactive. I would think that mandatory retroactive legislation in the tax area would be unconstitutional, and, if not unconstitutional, I believe that it would set a very, very bad precedent for this country.

The CHAIRMAN. Well, I have seen some retroactive legislation around here. [Laughter.]

And we have not been before the Supreme Court on any of them that I can recall.

Mr. Podolin, unlike the ABA, you endorse the retroactive election. You would even go further and allow interest on those refunds so they would achieve a result better than the position that they originally took on their tax return. How can you defend that kind of a windfall?

Mr. PODOLIN. Defend it largely on the basis of reducing controversies and achieving simplification; getting a lot of cases out of the administrative appeals and judicial process that would otherwise go on for any number of months, or for years.

I do not know necessarily that it is a windfall. There are possibilities that taxpayers would come out worse with the elected retroactivity than they would if they simply process their cases through the system and won.

The CHAIRMAN. Well, let me ask about your organization. I was noticing on Senator Pryor's legislation that you strongly, strongly endorsed the provision that Treasury regulations ought to be prospective. How do you square your position now with that?

Mr. PODOLIN. I do not recall our specific testimony on that. We believe that, in general, regulations should be prospective in order to provide certainty and that they should be retroactive only when that has a specific policy purpose.

I do not think that is inconsistent with our present testimony, Mr. Chairman, on the basis that this is elective retroactivity to clean up matters that are otherwise in dispute.

It is not intended that it be mandatorily retroactive, which we would oppose, because that would create all kinds of filing require-

ments and amended returns, and so on, for companies that otherwise would not be affected by this.

The CHAIRMAN. Mr. Faber, let me get your reaction to some of the requests for exceptions. How about on covenants not to compete and customer lists?

Mr. FABER. Well, I would say, in general, we oppose exceptions. It seems to me that in business acquisitions drawing a line between a covenant not to compete and a payment for goodwill is very difficult.

In my experience as a lawyer who works in corporate acquisitions, a lot of the allocation issues arise in connection with that distinction. So, we would not favor carving out covenants not to compete.

On customer lists, again, they are very hard to value and to separate from goodwill. It seems to me that to carve out an exception for customer lists would also recreate the same kind of complexity that we now have in the current system and we would oppose it.

The CHAIRMAN. Mr. Kies, as I understand it, your coalition supports both S. 1245—Senator Daschle's and Senator Symms' bill that provides for the amortization of customer-based and similar intangibles over their useful lives—and the 14-year intangibles amortization legislation, assuming that existing cases are addressed. Which of the two approaches do you favor on a going forward basis, and why?

Mr. KIES. Mr. Chairman, on a going forward basis, our group favors the 14-year rule, notwithstanding the fact that, for most of our members, that would provide them with a less generous result than they currently claim on their returns.

One of the points you made in your opening statement is, you hear from all of the losers, but not the winners. Our group is a group of the losers, but we support the 14-year rule because. Unlike most tax elections or tax changes, there is a third party in this equation.

That is the lawyers, accountants, and valuation experts that would be put out of the picture. In effect, the 14-year rule provides the opportunity for the FISC and taxpayers to share that benefit.

As a result, our members, even though they currently recover on insurance expiration lists over a 5 to 7-year period, would take 14 years, which would give them a less generous result, even including the amortization of goodwill.

But it would give them certainty and it would give them the assurance that they would not have to hire tax professionals to defend themselves against the Internal Revenue Service. And, for that reason, we would prefer the 14 years going forward.

We like Senator Daschle's approach to solve the controversies of the past, because the current position of the Internal Revenue Service is, even if a taxpayer can demonstrate fair market value and useful life of an asset, that they cannot amortize it if it is acquired in connection with a transaction in which goodwill is also acquired.

We think that is not consistent with the decision this committee made in 1987 to reject legislation that would have eliminated amortization of customer-based intangibles, and we do not think it is

consistent with what taxpayers reasonably anticipated was the treatment of these assets when they acquired them.

The CHAIRMAN. Well, that is a strong statement. Senator Danforth.

Senator DANFORTH. I want to address the retroactivity question. I guess, starting with you, Mr. Suess, and then maybe down the line.

As I understand it, if this legislation is not applied retroactively, the problem is that a lot of these controversies would be unresolved and there would be tremendous legal and accounting expenses bogged down in court, and so on. That is the basic rationale for seeking retroactive application.

Mr. SUESS. That is correct.

Senator DANFORTH. And the concern on the other side, at least the principal concern, is that if there is retroactive application, then there could be a windfall. Companies would be filing for refunds and they would end up getting a windfall as a result of the retroactivity. Does that state the conundrum?

Mr. SUESS. I believe it does. And I guess what I would like to respond to with respect to the potential windfall, it seems to me there are three parties in this case.

There are those parties, like ourselves, who would end up with a significant cost if they made this election. But, for companies like ours, the benefit is the certainty it creates and the savings in the litigation costs.

Obviously, there are some companies who would get a refund. And if the government takes the money that we pay in and turn right around and give it to another taxpayer, so be it.

I am happy because we benefit from the savings in litigation costs and the reduction in controversy. It seems to me that if the legislation is revenue neutral, the government benefits as well.

Because not only does the government not have a revenue impact, but the government will, in that case, save all of its administrative costs in fighting the taxpayers, and that has to be fairly significant.

And, so, if it takes a windfall for a particular taxpayer to simplify this legislation, to simplify this highly controversial area, I would say we have got three winners and we really do not have a loser in this case.

Senator DANFORTH. Well, let me just ask you about a possible way out of this, a way to resolve it, dealing with the administrative problem. Supposing that we provided that taxpayers could not claim a refund if they elect retroactivity.

You have got the administrative benefit, you have got all the savings that you are talking about that your company would like to get. But you are just saying there is not going to be any refund.

Mr. SUESS. It is difficult for me to answer that for the entire group. I can answer that for my company, but my company is going to incur a cost. And, so, certainly for us, it is really not an issue. That is something that would have to be taken back to the group and allow the group to respond.

Senator DANFORTH. Well, obviously, if you had said to a taxpayer, hey, you get a windfall, the taxpayer would say, well, that is wonderful; we really want a windfall.

Mr. SUESS. Certainly.

Senator DANFORTH. On the other hand, there are those that think that that is really not what we want to do, that it is bad policy and that retroactivity should not be allowed for that reason.

So, it would seem to me, the way out of this situation is to say, well, you can have the benefit of retroactivity in order to clean up the law suits, to clean up the controversies, to go on with your other business. But we are not going to provide you with retroactivity for the purpose of getting a refund.

Mr. SUESS. I understand.

Senator DANFORTH. Does that sound like a reasonable compromise to you?

Mr. SUESS. To me, it does. Whether it does to our group, I cannot really respond.

Senator DANFORTH. All right. Mr. Kies?

Mr. KIES. Senator Danforth, I can respond for our group. I think our group would gladly accept that for this reason: for the typical insurance agency that is acquired, the insurance expiration lists might be worth maybe $100,000. As a result, the tax involved is probably $34,000 at the 34-percent rate.

If that taxpayer has to pay tax professionals to defend his amortization of that asset, he is going to quickly burn up the $34,000 of benefit before he justs gets warmed up. They would gladly accept certainty. We think Senator Daschle's approach—which is really not retroactive—says, if you can show useful life and fair market value, you get to recover the asset. The current position of the IRS is that you get no amortization at all.

Thus, an approach like you have suggested would be very acceptable because it would put to rest the controversies. And that is really our objective.

Senator DANFORTH. Mr. Podolin.

Mr. PODOLIN. Senator, I am not sure I entirely understand your question. But if it is that if electing retroactivity would result in a refund, and you would not get the refund, but if electing retroactivity would clear up the controversy but result in your paying additional tax, I think the companies who would have this so-called windfall would have to measure the costs of litigation, and accounting, and so on, against the foregoing of the refund.

Senator DANFORTH. They would be no worse off than they are now.

Mr. PODOLIN. Unless they predict that they are going to win in the present dispute. If it would result in the elimination or minimization of controversies it is possible that we would support that. But we would have to study it and discuss it.

Senator DANFORTH. Anybody else like to comment briefly?

Mr. FABER. Yes, I will. It is an interesting idea, Senator. I think this is an area where we have tradeoffs and where we have a need to eliminate controversies, but we also want to be fair.

If the proposal could be made applicable to all taxpayers who bought property after a certain date, whether or not their old taxable years are open on a going forward basis, then it could have a lot to recommend it.

I think that in order to explore that, however, you would have to make sure you looked at the revenue situation and made sure that it did not result in undesirable revenue losses.

Senator DANFORTH. Well, I mean, clearly, the revenue losses would not be the same as they would if you provide for refunds.

Mr. FABER. Absolutely. Absolutely. But, obviously, there could be a revenue loss on a going forward basis. I just do not know. As we said in our formal statement, we are not revenue estimators, but we are very concerned about the impact of anything like this on revenue.

And I am just saying it is an interesting idea. If it can be made fair to all taxpayers, we would not oppose it, provided there was not an unacceptable revenue loss.

Senator DANFORTH. Thank you.

The CHAIRMAN. Thank you. Let me provide you some information that apparently some of the witnesses have not been aware of as they have been asked questions.

There are new estimates by the Joint Tax Committee that show that the retroactive election provision results in a very substantial loss to Treasury in revenue; that the loss during the 1992 to 1997 period would be $3.2 billion; that without the retroactive election you would actually have a gain of $400 million during that period.

I am sure the statements that a couple of you made was without an awareness of the new estimates, so you might keep that in mind.

I would also like to ask all the panelists if they have any objections to written questions being written to them—if they would reply to us, because of the restraints on time.

Mr. PODOLIN. We would be happy to.

The CHAIRMAN. Are there any objections?

Mr. PODOLIN. Of course. We would be glad to do that.

The CHAIRMAN. That is fine.

Senator Daschle.

Senator DASCHLE. Thank you, Mr. Chairman. I apologize for not being here at the beginning. I appreciate very much your willingness to hold the hearing and your leadership in this area again this morning.

As several of our witnesses have alluded to, S. 1245 which essentially codifies the current case law on this issue.

My intention, if the bill had been enacted, was to clarify for the IRS that intangible assets may be amortized over their determinable useful lives, provided, of course, that the taxpayer can demonstrate that the asset has a discernible value separate from goodwill and a reasonably determinable life.

The high level of interest in this issue became clear to me after the bill was introduced. I heard from an array of industries which offered their insights and related their experiences with the tax treatment of acquired intangibles.

But, then, my good friend and colleague, Chairman Rostenkowski, offered a much more bold initiative to dramatically simplify the law in this area, and I really have not heard from anyone since. [Laughter.]

I commend the Chairman for his initiative, not only in offering his proposal, but also for his persistent efforts to work with various

industries that are affected and resolve the concerns that they have.

As an example, I point to the language included in the conference report on the recently vetoed Tax Fairness and Economic Growth Package that made clear that interests in films, sound recordings, videotapes, books, and similar property were not to fall within the scope of this bill.

If this committee decides to go forward on a separate track with the intangibles issue, I hope the same language will be included. Otherwise, our intellectual property industries could be significantly disrupted.

I understand that a great deal of work has gone into the perfection of the Rostenkowski proposal, and that effort should not be wasted.

Obviously, the two areas of greatest concern have to do with the issue that Senator Danforth and our Chairman raised, and that is retroactivity, as well as the 14-year amortization.

I was interested in the statements made by Mr. Goldberg. I was not here to hear his statement, but, in reading his testimony, I noted that he raised a couple of issues we have been talking about this morning. I think it is important that we try to flesh these out to the extent we can.

One that I think is worth discussing in the context of retroactivity is his concern that this really will not resolve the pending controversies. He says, because it is elective, taxpayers who believe they have marginal cases will elect retroactive application.

But taxpayers who believe they have strong arguments for amortizing intangibles over a period shorter than 17 years will continue to litigate. So, he asked the question: How does that resolve the issue? Mr. Kies, could you address that?

Mr. KIES. Yes, Senator. I think one of the aspects that Assistant Secretary Goldberg's testimony did not really address well was the fact that there are many taxpayers, like our taxpayers, who would take the 14-year rule going forward which is less generous than they claim on their current returns. They will take that to get certainty and eliminate the professional fees associating with valuing assets and then dealing with controversies with the IRS. I think to some extent the same thing is true of some people that would elect the 17-year rule.

Our preference for the past cases is not for the 17-year rule, but it is rather to take your legislation and apply it to the past. But the 17-year rule, we think, would be elected by many taxpayers, perhaps even including some of our own members, who would get a substantially less generous result than that which they have claimed on their original tax returns, but would get certainty and avoid the costs of having to contest the tax treatment in the courts or with the Internal Revenue Service.

And, as I said, if you are an insurance agency and you acquire an asset that has a $100,000 value with $34,000 of tax benefit, you can lose all of that very quickly by just having to fight with the IRS because of the cost of professional lawyers, accountants, et cetera. So, I think that is an element that perhaps Assistant Secretary Goldberg has not completely taken into account.

Senator DASCHLE. Would anybody take issue with Mr. Kies on that point? Is there common agreement that that is a fairly accurate interpretation?

Mr. SUESS. Yes. I guess I would like to comment that I concur completely with what he said. I believe that Mr. Goldberg has underestimated the number of taxpayers who would elect this and yet incur a substantial cost.

The benefits of certainty are substantial to taxpayers. And the ability to get certainty and close out contentious issues that will take years to work through the system is well worth it.

And I have personally spoken with many taxpayers who are in similar positions to our company who would be willing to incur costs in order to get the certainty.

Senator DASCHLE. Let me ask real quickly a second question for anybody who may wish to answer it. Mr. Goldberg raises an interesting dilemma. He does so by offering an example, which is to consider a leveraged buy-out transaction dating back many years which was priced on the basis that goodwill could not be amortized.

All the benefits of a retroactive election to amortize goodwill over 17 years would accrue to purchasers, no benefits would accrue to the selling public shareholders. Number one, do you agree with that, and, secondly, how would you deal with that? Yes, Mr. Kies.

Mr. KIES. I think it depends on whether you do something like Senator Danforth suggested, which is to try and take some of the windfall element out. That is one potential approach where you could deal with some of that problem.

Senator DASCHLE. So, you agree that the problem exists, and you agree that we can find a way legislatively, perhaps as Senator Danforth has suggested, of equalizing the impact of this somewhat?

Mr. KIES. Senator Daschle, I think that theoretically the problem exists. I do not think anybody up here has—I do not have a transaction I can tell you about where the windfall actually exists, but certainly it is easy to look out and see some transactions where it might exist.

If you were to use the approach of Senator Danforth, you might be able to reduce the 17-year period to 14 years and we would probably encourage more people to take the election and settle more cases because you would not have the windfall element that Senator Bentsen referred to in the most recent Joint Committee estimate.

Senator DASCHLE. All right. Thank you very much for your answers.

Mr. PODOLIN. Senator, I just wanted to add to that, I do not know that I would necessarily characterize that issue as a problem. I think the analysis is correct: there would be benefits to purchasers in those situations.

But when a company is acquired, whatever happens from that date onward is to the benefit or detriment of the purchaser. If it is bad, for example, an unknown liability suddenly materializes, that is normally who would pay it. And if there is a windfall, if you want to characterize it that way, that is normally who would get it. I do not see this situation as any different.

Mr. FABER. You could also have an increase in tax rates which would increase the benefit of any amortization deductions that are

there. But I do not think that is really pertinent to the kind of policy decisions that we have to deal with here.

Senator DASCHLE. Well, my time is up. Again, I would thank you all. Thank you, Mr. Chairman.

The CHAIRMAN. Did you say increase the tax rate? [Laughter.]

Mr. FABER. It would increase the tax benefit from the amortization. It changes the economics of that acquisition.

The CHAIRMAN. We have just been through that one. Senator Packwood.

Senator PACKWOOD. Mr. Suess, how long has the Coalition for Open-Year Elections been in existence?

Mr. SUESS. It has been a matter of months now. I believe 5, 6 months.

Senator PACKWOOD. How many members?

Mr. SUESS. We have roughly 20–30 members.

Senator PACKWOOD. Could you give me a list of who those members are?

Mr. SUESS. I do not have a current list, but I would be happy to provide you with a response in writing.

Senator PACKWOOD. When you say "current list," are members coming on all the time?

Mr. SUESS. Yes.

Senator PACKWOOD. All right.

Mr. SUESS. It is an ever-changing list.

Senator PACKWOOD. If you could give me a list as current as you can make it, I would appreciate it.

[The list follows:]

COALITION FOR OPEN-YEARS ELECTION, MAY 5, 1992

AIM Management Group, Inc.
Baker Hughes Incorporated
Black & Decker Corporation
Citicorp/Citibank
Coastal Healthcare Group, Inc.
First Brands Corporation
Gillette Company
Hershey Food Corporation
Honeywell, Inc.
International Multifoods Corporation
J. M. Huber Corporation
Levi Strauss & Co.
Mayne Nickless Holding Co.
Philip Morris Management Corporation
The Prudential Insurance Co. of America
The Standard Corporation
Tandy Corporation
Unilever United States, Inc.
Union Pacific Corporation
U.S. Bancorp
The Vons Companies

Senator PACKWOOD. The Chairman alluded to the problem that the Joint Committee has raised about the cost on retroactivity.

But, in answering one of the questions, you indicated that you are not sure that you can give the number of transactions or the size of the transactions. So, you would have no way of knowing whether the Joint Committee's estimate was right or wrong.

Mr. SUESS. That is correct.

Senator PACKWOOD. Would anybody else on the panel have any idea of knowing whether their estimate is right or wrong, or are you all in the same position that Mr. Suess is in? Ken, let us just start with you and go across.

Mr. KIES. Well, the only thing I can be sure of, Senator Packwood, is that the estimate is probably wrong because it is almost impossible to get it right. That is why they call them estimates, I guess. [Laughter.]

But the Joint Committee is probably in the best position with the data they have to analyze what the impact of some of these legislative proposals would be.

Likewise, they are probably in the best position to analyze whether Senator Danforth's approach would eliminate that revenue cost, and I would hope that is something they would take a look at.

Mr. PODOLIN. I do not know if the estimate is right or wrong. However I have been surprised by, but now have become used to, the fact that many taxpayers that we have talked to would favor the elimination of the dispute, even if it cost them some taxes.

Mr. FABER. Again, I cannot comment on the accuracy of the estimates. But, my sense, again, anecdotally, from talking to companies, is that there are big dollars involved.

Mr. WILLIAMS. Yes. I would tend to agree. Except I would make the point that anecdotally, too, I have heard from some of our corporate members that they would take the open-year election, even though they may come out better pursuing litigation through to its fruition. But, other than that, I cannot comment on the specific figure.

Ms. NULTY. As I recall, the GAO study came up with a figure in the neighborhood of $23 billion of intangible assets that were being challenged under this provision of the tax law. I am not sure if my recollection is correct, or not.

Senator PACKWOOD. That, I do not know. All I know is the Joint Tax Committee's estimate.

Ms. NULTY. I know. I am saying that we have not done any calculations with respect to retroactivity because we are concerned about prospectivity. But, leaving that aside for a moment, I think the problem is that you have enormous asset values at stake here.

And whether it be retrospective or prospective, I am somewhat concerned that the larger question of the magnitude of the goodwill component and the size of the goodwill component, if you were to have a rather narrow definition and much more conservative approach to which types of intangible assets could be amortizable——

Senator PACKWOOD. Well, let me ask either you or Mr. Baker this question.

Ms. NULTY. Yes.

Senator PACKWOOD. Would you object to this legislation if goodwill was not deductible?

Ms. NULTY. Well, the problem is how much scope you allow for the rest of intangible assets. Because that is where the litigation comes from, is trying to reduce, as much as possible, that component that is "pure goodwill" by creating all kinds of invented asset classes.

Many of them, to us, seem quite questionable and imaginative. You simply have a bunch of clever lawyers, and perhaps accountants and valuers coming up with——

Senator PACKWOOD. With things that they would say is not goodwill, but you would say is goodwill.

Ms. NULTY. Exactly. Exactly. Exactly. Because there is not an attempt to separate the value of an asset from being part of a going concern. And that is really the issue we are trying to address and that we feel legislation needs to address.

Senator PACKWOOD. But, if there is this inability to very easily separate goodwill from other assets that you would think are goodwill and somebody else would think is not, what is your solution, then, as to how to draft this legislation?

Ms. NULTY. Well, we think that there clearly has to be legislation. And we feel that there is pressure on Congress to act, and Congress needs to act. We think that Congress has successfully set up—I do not remember if it was three or four asset classes for tangible assets—that there are some intangibles that are bought and sold independent of acquisition activity.

And there are known markets for those asset classes; there are known useful lives, there are known prices that are market-determined, separate and apart from acquisition of going concerns. And Congress should establish, or could establish a narrow, clearly-defined, explicit group of such asset classes.

Senator PACKWOOD. But do you have any suggestion as to what those are?

Ms. NULTY. We would need a lot more time than the time we have had to prepare for these hearings to offer some suggestions in that regard. I mean, I do not think that anyone can come up with a simple answer.

Senator PACKWOOD. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Gentlemen, we have five more witnesses in the next panel. If you feel like you cannot defer further questions, why, these are available. Otherwise, we will go on to the next panel. Thank you very much.

Our next panel consists of Mr. Stephen Ashley, who is chairman and chief executive officer of Sibley Mortgage Co., and vice president of the Mortgage Bankers Association of America; Mr. Curtis Uhre, who is the president of the Home Finance Coalition; Dr. Robert Cooper, president and chief executive officer of Atlantic Aerospace Corp., on behalf of the American Electronics Association; Mr. William Benac, who is the Treasurer of EDS, on behalf of the Information Technology Association of America; and Mr. John Buckley, president of the Buckley Co., on behalf of the Committee on Taxation of Intangible Assets.

Gentlemen, we are pleased to have you. Mr. Ashley, representing the Mortgage Bankers Association of America. If you would proceed.

STATEMENT OF STEPHEN B. ASHLEY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SIBLEY MORTGAGE CO., ROCHESTER, NY, AND VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. ASHLEY. Good morning, Mr. Chairman and members of the committee. I am Steve Ashley, CEO of Sibley Mortgage Corp., located in Rochester, NY, and vice president of the Mortgage Banker's Association of America.

The MBA is the largest trade association that represents originators and servicers of home mortgages. MBA has a keen interest in any legislation that affects the ability of homebuyers to purchase a home.

The intangibles title in H.R. 4210 would detrimentally impact the home lending industry. While MBA applauds the intangibles

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title as a significant step towards clarifying and providing uniformity to a very controversial area of the law, we strongly believe the simplification aspect of the title is being championed to such an extent that many long-term risks to the economy and to consumers are being overshadowed or overlooked.

Mortgage servicing is a strip of the mortgage loan's interest rate and is compensation for various administrative services performed. The servicing fee is based on the life and outstanding principal balance of the mortgage loan.

The vast majority of mortgage servicers amortized servicing rights for book and tax purposes over a 7 to 10-year period by using an accelerated amortization method.

The methods used to amortize mortgage servicing rights are designed to attract the diminishing economic value of the assets. These assets decline in value because of mortgage prepayments, defaults, and the normal attrition of lending.

The proposed legislation, if implemented, would be the equivalent of establishing a depreciation schedule for a building structure or a piece of machinery considerably longer than its true economic life.

The Congress should not begin a policy of establishing longer tax lives for established intangibles which already have accepted tax lives that correlate to the underlying assets.

Mortgage servicing is different from other intangibles. It is marketable, severable, and quantifiable. These characteristics are usually found only in tangible assets and make PMSR different from credit card receivables and other intangibles.

PMSR is a key component of the established secondary mortgage market. As such, the change proposed will alter the pricing of the underlying mortgage product. Currently, PMSR has a predictable life, a measurable life, and is freely traded.

The Federal Reserve, the Office of the Comptroller of the Currency, the OTS, and the FDIC have all deemed PMSR to be the only intangible that is eligible for inclusion in Tier One capital for risk based and leverage capital purposes.

In addition, PMSR already has an IRS tax court acceptable measurable life. The intangibles title would undo existing tax law by creating an arbitrary life for the asset.

Let me now discuss the market impacts of the proposed change. This change to the amortization of the PMSR would devalue the market value of servicing, reduce the ability to trade the asset, increase borrowing costs for the homebuyer, and increase the cost of the S&L bail-out.

Requiring a 14-year amortization period for PMSR will increase the tax burden on PMSR's. Because investors in mortgage servicing would be required to write off the value of their acquired mortgage servicing over an artificially long time period, they will incur a tax burden by owning mortgage servicing.

That is, owners of servicing would be forced to amortize servicing after the underlying asset no longer exists. Consequently, the price that investors would be willing to pay for the asset would be reduced commensurate with the increase in tax burden of owning the asset.

The decline in number of investors and the price of the asset would be solely due to the 14-year amortization provision. The mortgage lending industry is equally concerned that the proposed change in amortization would significantly reduce the value of the mortgage servicing as an asset.

That devaluing would have a significant impact on the RTC. Servicing has been one of the assets that the RTC has been able to dispose of with relative ease. MBA estimates that the value of all servicing rights would be reduced by 6 percent if the change in amortization is enacted.

The RTC has $40 billion in servicing remaining to sell. This servicing is valued at between $400–$600 million. If this change is enacted, the value of the RTC servicing will be reduced by as much as $36 million. The reduction would occur solely because of the change in amortization.

Mortgage servicing is freely traded at a rate of about $200–$300 billion per year. The IRS has deemed PMSR's to be actively traded. There is a market with servicing brokers, buyers, and sellers. The broker, as the seller's agent, distributes the data to potential buyers; offers are made.

This competitive theory would be significantly curtailed if PMSR's were required to be amortized over 14 years. Less competition for PMSR would result in greater concentration of servicing in the hands of a few. Consumers would have higher costs, and possibly fewer borrowing choices.

Let me just conclude, Mr. Chairman, by saying that MBA strongly opposes extending the amortizable life of mortgage servicing. Including PMSR's, into the tangibles title would add unnecessary costs to consumers as they attempt to buy a home, fundamentally alter the existing competitive market, and add to the cost of the thrift and the clean up. Thank you very much.

Mr. CHAIRMAN. Otherwise you think it is all right, huh? [Laughter.]

[The prepared statement of Mr. Ashley appears in the appendix.]

The CHAIRMAN. Mr. Uhre. Pronounce your name for me, please.

Mr. UHRE. Mr. Uhre. Curt Uhre, Mr. Chairman.

The CHAIRMAN. We are delighted to have you.

STATEMENT OF CURTIS B. UHRE, PRESIDENT, HOME FINANCE COALITION, INC., WASHINGTON, DC

Mr. UHRE. Thank you for the invitation to appear before the committee here this morning. I am president of the Home Finance Coalition. The Home Finance Coalition is a trade association of mortgage servicers whose members service about $80 billion of home mortgages for approximately 1.6 million homeowners across the country.

The Home Finance Coalition is opposed to the inclusion of mortgage servicing rights in the intangible simplification section of the Tax Fairness and Economic Growth Act of 1992.

The coalition believes one should not take assets with known useful lives and artificially lengthen those lives to 14 years. In the case of mortgage servicing rights, this means increasing the average life of approximately 7 to 10 years to 14 years.

The home finance industry has changed dramatically over the past years. It is now generally divided into three segments: the loan originator, the mortgage servicer, and the mortgage investor.

Every time a mortgage loan is originated and sold to Fannie Mae, Freddie Mac, or GNMA, or any other private investor, a mortgage servicing right is created. A mortgage servicing right is nothing more than the right to receive a small portion—usually 25–50 basis points—of the interest income of a mortgage.

In return, the mortgage servicer collects the monthly mortgage payments, pays the investor, and ensures that taxes and insurance are timely paid. The remainder of the loan is sold to the mortgage investor.

Usually the mortgage originator, in addition to selling the loan to the secondary agencies, will also sell the mortgage servicing right to an institution who specializes in servicing mortgages.

These mortgage servicing rights are sold through all of the major Wall Street securities firms, and other small companies who specialize in this marketplace. Last year, the rights to service approximately $200 billion worth of mortgages were sold. It is a very active and liquid market.

At the time that the mortgage loan is originated, the loan originator knows that he will be able to sell the mortgage servicing right for between 1 to 2 percentage points of the underlying mortgage.

The mortgage originator effectively credits this amount to the home borrower at the time the loan is originated, thus requiring the home borrower to pay less points or closing costs at the time the loan is originated.

Many industry experts believe that the proposed intangibles legislation would decrease the value of mortgage servicing rights by approximately 30 percent.

Attachment A to the coalition's testimony provides simplified documentation of what this would mean to the value of mortgage servicing rights.

By requiring a 14-year amortization instead of a normal 7-year amortization, the value of the mortgage servicing right for a $100,000 mortgage is decreased by $500. This decrease in value will be passed on to the home borrower, who will have to pay an additional $500 at closing.

The net result of this legislation, then, will be to decrease the value of mortgage servicing rights, and, thus, increase the borrowing costs for the home borrower.

The rationale given for the intangible tax simplification legislation is that it will eliminate legal battles and problems in allocating asset value.

Neither of these problems currently exist for mortgage servicing rights. These assets are bought and sold independently on a standalone basis. They are traded on their own.

Second, these assets are amortized over the actual life of the loan, and there are no outstanding problems with the IRS regarding the current method of amortization.

This legislation would not eliminate any problems for the IRS, but, indeed, as we have shown, would increase the borrowing costs for the homebuyer.

The Home Finance Coalition is aware that the Joint Committee on Taxation has estimated that including mortgage servicing rights within the proposed 14-year amortization schedule will increase tax revenue by $1 billion over a 5-year period of time.

We believe this number to be high. But, in any event, we believe it will be substantially reduced, if not totally eliminated, for two reasons.

First, any increased tax payment by mortgage servicers will be offset by a like amount of decreased tax payment by homeowners. It is true that the legislation will increase tax revenue for intangibles, and, thus, the mortgage servicers will pay more in taxes.

However, the increased dollars received from the mortgage servicers would be lost as the homebuyers increase their tax deduction due to the increased points they will have to pay for home finance.

In other words, whatever is gained from the mortgage servicers from the intangible legislation will be lost in the deduction for points which a home buyer is allowed to take on his tax return.

Lastly, we would like to point out that the legislation, as currently drafted, would immediately reduce the value of mortgage servicing rights held by a mortgage servicer and would not be prospective in nature.

Well, it is true that as long as the servicer holds the servicing, he could use the old amortization period. If he were to sell the servicing to the new buyer, the new buyer would have to use the new period.

In conclusion, Mr. Chairman, the Home Finance Committee believes that the inclusion of mortgage servicing rights will increase borrowing costs. The present system is working well. And we would ask that mortgage servicing rights be exempted from any 14-year amortization period. Thank you very much.

The CHAIRMAN. Do you think the gain in revenue there equates to what would happen with the extra points and so on with the homebuyer?

Mr. UHRE. Yes, Mr. Chairman, we do. Because the economics of home origination is such that the originator gives a credit to the homebuyer and the numbers have to remain the same. So, whatever you receive from the servicer, I think that the homebuyer is going to have a like increase in deductions.

[The prepared statement of Mr. Uhre appears in the appendix.]

The CHAIRMAN. Dr. Cooper, if you would proceed. Dr. Cooper is speaking on behalf of the American Electronics Association.

STATEMENT OF ROBERT S. COOPER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ATLANTIC AEROSPACE CORP., GREENBELT, MD, ON BEHALF OF THE INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA, ARLINGTON, VA

Dr. COOPER. Thank you. I am Bob Cooper, and I am here to discuss the bill for the American Electronics Association, the Nation's largest electronics association, with over 2,700 members.

In addition to leading U.S. computer, semiconductor and software companies, AEA also represents the industry's emerging companies. Over 80 percent of our membership consists of small entrepreneurs with fewer than 200 employees.

Now, I am not a lawyer and I am not a CPA; I am an engineer. And I am here to try and interpret for you what the impact of this bill may be on the high technology industry that I represent.

We appreciate the House and Senate excluding software from the proposed intangible depreciation provisions. However, we are here today because this software exclusion does not encompass other crucial U.S. high technology that merits similar consideration.

In the last 20 years, we have seen a move in our industry from material-intensive production to knowledge-based production. The driving force in this move is high technology. The key to being competitive in the 21st century is going to be high technology.

How do you define high technology? Well, in net, in plain terms, high technology is the intellectual property forming the real, underlying value and competitive advantage in all of our products. It is our most valued intangible asset.

In our industry, it does not last 14 years. Examples of some of the fast-moving advanced technologies involved are: super-conductivity, opto-electronics, advanced video displays, space technology, software, biotechnology, and semiconductor manufacturing technology, just to name a few.

We support efforts to bring increased certainty and simplicity to the Tax Code. This largely benefits very large corporations, but that is not where the action is now and not where it will be in the 21st century. It is with that 80 percent of smaller companies that are involved in high technology.

However, this legislation gives a significant advantage to foreign competition in acquiring critical infant U.S. technology. By extending current depreciation schedules to 14 years, H.R. 4210 raises after-tax cost of technology acquisitions by 12–20 percent.

Tax law, for most foreign competitors, allows writeoffs of newly acquired technologies in 5 years, or less, and sometimes immediately. H.R. 4210, in effect, puts U.S. companies at a severe disadvantage in bidding to retain U.S. innovation.

Since we now have parity in international competition under U.S. tax law, we ask the committee to amend H.R. 4210, Section 4501 to, first of all, exempt the purchase or license of high technology intellectual property from the 14-year depreciation schedule. And, secondly, to provide a rule that would apply to the acquisition of small high technology companies.

Just to give you a feeling for some of the potential adverse impacts of this proposed measure, I would like to cite some examples, from recent experience, of Trimble Navigation, which is a company that I am also on the board of. Trimble is an example of one company which is an aggressive USGPS industry.

That is the Global Position System that was developed by the Defense Department and placed in operation recently which has significant commercial application. The world market opportunity that was created in this $12 billion taxpayer investment is substantial.

U.S. industry has an early lead in exploiting commercial applications of this system, but the final outcome depends on a level worldwide playing field.

To ensure its part of the lead, Trimble must supplement in-house R&D and extend its GPS technology with acquired licensed application-specific technology. And it has been doing that vigorously.

The following examples illustrate the potential negative impact of the legislation's proposed 14-year depreciation schedule on both Trimble and its customers.

In 1989, Trimble acquired GPS tracking system engineering know-how from Tau Corporation. Trimble then developed a GPS-based vessel tracking and monitoring system. The product adds another level of safety in preventing disastrous oil spills, such as the Exxon Valdez spill in Alaska.

U.S. commercial shipping is already investing in these systems to improve safety and to increase fleet operating efficiency. Because of already tight profit margins, the impact of H.R. 4210 would likely be the slowing of the investment in these systems because of increased cost.

This GPS tracking know-how is also critical to the public and the Federal Aviation Administration in improving airport safety. GPS tracking technology will help prevent airplane and vehicle collisions on airport runways, similar to the recent Los Angeles Airport disaster.

H.R. 4210 not only would impede Trimble's ability to product innovative products for these new safety applications, but it would delay the potential availability to benefit the public, as well.

In summary, we ask that you continue current practice by excluding advance technology from the proposed intangible depreciation provisions of H.R. 4210. We believe electronics is the crown jewel of our high technology industry and it should not have the burden that is placed on it by these provisions.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Cooper appears in the appendix.]

The CHAIRMAN. Mr. Benac, on behalf of the Information Technology Association of America.

STATEMENT OF WILLIAM P. BENAC, TREASURER, ELECTRONIC DATA SYSTEMS, DALLAS, TX, ON BEHALF OF THE INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA, ARLINGTON, VA

Mr. BENAC. Thank you very much, Mr. Chairman. I am William P. Benac, treasurer of Electronic Data Systems, headquartered in Dallas, TX.

EDS is one of the Nation's largest providers of software-based information technology services to the Federal Government and customers in a broad range of industries, including health care, financial services, insurance, manufacturing, communications, and energy.

EDS employs 70,000 people in more than 30 countries around the world, and had 1991 revenues of more than $7 billion.

I am here today on behalf of the Information Technology Association of America. ITAA is the trade association of this Nation's computer software services industry, whose more than 36,000 companies provide government and corporate America with business application and system software for mainframe, mid-range, and personal computers; custom and contract software programming serv-

ices; information systems integration services; and information processing services.

In 1990, the last year for which figures are available, U.S. Information Technology companies generated over $100 billion in revenues, an increase of 12 percent over the previous year, and employed more than 1 million people.

According to statistics in the 1991 "U.S. Industrial Outlook," our industry is the most rapidly growing industry in the Nation. The United States leads the world in information technology.

And even during this period of economic downturn, the United States information technology industry is contributing positively to the Nation's economy and balance of trade.

Computer software is the subject of my presentation, and it is critical to the information technology industry and to American industry in general.

As you know, Mr. Chairman, ITAA applauds the goal of meaningful tax simplification. At the same time, however, the success of the U.S. information technology industry depends on well-established tax rules that recognize the business and technological realities of computer software.

We are concerned that the impending intangibles legislation, even as amended by H.R. 4210, is not in harmony with the technical and business realities of the software industry.

This legislation will impede the ability of the U.S. information technology companies to compete in the world market by effectively raising the cost of computer software obtained through business acquisitions by between 10–15 percent.

The intangibles provisions of H.R. 4210 would impose a standard 14-year amortization period for virtually all intangibles acquired in connection with business acquisitions.

The proposed legislation includes a very limited exception primarily for off-the-shelf software. However, this exemption does not apply to business acquisitions when the acquiror obtains ownership rights in software, as distinguished from the mere right to use a copy.

I would like to emphasize a few points that I believe are critical to the proper tax treatment of software. For more than 20 years, the IRS has allowed software to be amortized over 5 years or less. A 14-year amortization period for software bears no relationship to its actual useful life.

For example, the popular software program, 1-2-3, from Lotus Development Corp., was introduced 9 years ago in 1983. Since then, there have been five major releases of that program, each replacing the previous version, the latest being in August of 1991.

Likewise, the complex mainframe software used to power sophisticated banking and airline reservation systems is upgraded and enhanced frequently because of advances in both software and hardware technology.

At EDS, the computers in our large information processing centers are typically upgraded as often as every 18 months, meaning the software must be changed at the same time.

Moreover, virtually all of the major U.S. trading partners allow software acquisition costs to be written off over 5 years or less. Canada, France, Germany, with its 3-year writeoff, Japan with 5

years, and the United Kingdom, to name a few, allow the amortization of software acquisition costs over 5 years, or less. A 14-year period for software in the United States would give a comparative cost advantage to our international competitors.

Computer software differs significantly from customer-based intangibles, such as goodwill, which are addressed by the proposed legislation. Software is readily identifiable. It is capable of reasonable valuation. And the tax treatment for software has not been the source for the legislation which is currently before this committee.

In summary, I would like to conclude with the fact that we believe that the current tax legislation which has served this country well, will provide what we need, a level playing field, to support this industry which is projected to account for 14 percent of the gross national product of the world by the year 2000. We need a level playing field so the United States can maintain its international lead in this critical area.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Benac appears in the appendix.]

The CHAIRMAN. Mr. Buckley, on behalf of the Committee on Taxation of Intangible Assets.

Mr. Buckley.

STATEMENT OF JOHN G. BUCKLEY, PRESIDENT, THE BUCKLEY CO., BOSTON, MA, ON BEHALF OF THE COMMITTEE ON TAXATION OF INTANGIBLE ASSETS

Mr. BUCKLEY. Thank you, Mr. Chairman. I am Chairman of an ad hoc group of independent home heating oil retailers, more than 2,000 of them, from the States of Oregon, New Jersey, New York, Connecticut, Rhode Island, Massachusetts, Vermont, New Hampshire, and Maine.

These are mostly family-owned companies, and our ad hoc group was set up, quite frankly, because these companies and the individual businessmen and women are worried, concerned, and frightened that H.R. 4210 will seriously diminish the value of their businesses.

Our problem, Mr. Chairman, is that the value—the asset value—of a retail home heating oil business is made up primarily of intangibles, and I mean 80–90 percent of the total value. The total tangible assets consist of a couple of trucks, a service van or two, and that makes up the balance.

The principal value upon sale of a firm is a customer list and a non-compete contract to protect the value of that list.

The owner and spouse typically are hometown people, spend their lives keeping other people warm in the winter time, servicing customers 24 hours a day, and they are usually very active in civic affairs, church affairs, hospitals, and civic organizations.

The customer list, built up over a lifetime, is the principal asset of the firm. A contract with the owner not to compete, obviously, is key. Because without such a contract, an owner could retire for 6 months and then call back his old customers and most of them would come right back to him. So, a non-compete contract is important and generally runs for 5 years and is amortized over that period.

The lifetime of a customer list, once sold, tends to run from 6 to 8 years. Perhaps the average is around 7 years. The reason for that short period is because the industry is very competitive. There is competition among oil dealers, and there is competition between oil dealers and gas and electric utilities.

Because of the very high percentage of intangibles in the total asset value and the very low percentage of goodwill, H.R. 4210 causes a significant decline in the value of a heating dealer's life's work.

I am sure it was not intended, but when you wake up 1 day and find out that your life's earnings are down by 10, 12, or 15 percent overnight, not by a change in policy, but because of a simplification measure, that is not fair.

Make no mistake, we support this committee's effort to end controversy and simplify this area of tax law, although, in our industry there has been little controversy over the last 20 years. All cases have been decided the same way, and they all have run in our favor.

But, we believe the Nation needs simplification and the certainty that comes with simplification. Moreover, I think the combination of H.R. 3035 introduced by Chairman Rostenkowski last year and our own feeling that he is very, very strongly supportive of that effort, creates some uncertainty because it is so dramatically different for our industry, from current law.

And, the Supreme Court's decision to grant cert on the Newark Morning Ledger case really creates more uncertainty for the next year until that case is decided. So, right now, no one knows how to value their business. Thus, we need legislation to end that problem.

The negative impact of H.R. 4210 on the small businessmen I represent here today can really be alleviated with a very simple change that allows covenants not to compete to be amortized over their actual contract term, just as they are under current law.

This modification would permit purchasers of small businesses to amortize the value of the covenant not to compete over the actual contract term, which is usually 5 years, rather than 14 years.

To prevent any possible abuse of the type that concerned Secretary Goldberg this morning, we think the language could be drawn rather tightly to limit the overall scope of the provision to small businesses, the provision could restrict the amount allocable to the covenant to no more than 40 percent of the value of the intangible assets transferred with an absolute maximum of $2 million.

In addition, the rule could be further limited to transactions with total asset values of under $10 million, or some other appropriate number.

This change would preserve the asset value of the heating oil dealer and similarly situated small business at or near current levels. It would have very little effect on revenue.

In our own industry, we believe that the proposed modification would be approximately revenue neutral in comparison to current practices and would cost, perhaps, $1.5 million to $2.5 million annually in comparison to H.R. 4210.

This amounts, really, to the annual diminution in value that would be suffered by heating oil dealers who sell out if H.R. 4210 is enacted unchanged.

Please remember, however, that while the number of sales of companies each year is very small, the reason the whole industry is concerned is that it impacts all of them.

Because when banks discover that the asset value of a company has declined, they, of course, are not willing to lend as much money. And this is an industry that needs a lot of money in the winter.

In short, Mr. Chairman, a major problem in fairness for many thousands of small, family-owned businesses can be corrected by a diminimus change in Treasury revenues and with no loss from current law.

We know that we are a pretty small business and pretty small on the scope that this committee is used to working with, tens and hundreds of billions of dollars, and we are talking about $2 million to $3 million a year.

We certainly appreciate that you have taken the time to hear our plea and are sincerely hopeful that (A) a new simplification law can be enacted, and, (B) that the simple modification that we have suggested can and will be adopted. Thank you very much, Mr. Chairman.

The CHAIRMAN. Well, that is an interesting proposal.

[The prepared statement of Mr. Buckley appears in the appendix.]

The CHAIRMAN. Dr. Cooper, this question of definition of high technology gives me some concern. I note that in your written testimony, you define high technology as any formula, process design, pattern, know-how, format, trade secret, or similar items, including software, firmware, hardware primarily attributable to research and development.

Now, at the risk of offending the sensibilities of a very sophisticated and very experienced engineer, let me ask you. Could this definition not include a number of intangibles not generally thought of as high technology? How about a formula for perfume?

Dr. COOPER. We think there is a very simple way to connect the definition of high technology appropriately to the part of the industry which is generating the future for us. And that, typically, is done by limiting the definitions to association with real expenditure of R&D funds.

Now, we are talking about companies here that typically are small, perhaps venture-financed. They may spend the substantial part of their useful life developing a technology, like several years, and then get to a point where that technology is purchased by a larger company or by another company and integrated into a particular product.

The definition of the technology and its relationship to the capital that was employed to create it is very easy to account for. And the value of it is very easy to account for because it is the venture capital that is put into it.

If we put an additional expense on that whole process of acquiring that technology, that means it is less likely that this country is going to be able to take technologies that come from our innova-

tive and creative capabilities in this country and put them into products. Others will be successful at doing that because they can buy them at 20 percent less expense.

The CHAIRMAN. Well, let me ask you another point, then, on this. You make the point that foreign acquirers would gain an advantage over U.S. acquirers in bidding for U.S. technology.

Now, if that technology is left here in the United States, it is subject to our laws. And I do not see that anything is lost there. It seems to me that the only loss is where that technology is then moved and taken to another country, not left here. Is that common?

Dr. COOPER. It is very common.

The CHAIRMAN. That it is not left here, not utilized here? Oh, come on.

Dr. COOPER. It is very common that that is the case in the electronics industry. A typical example is, perhaps, a design of a microprocessor. That microprocessor design, which may have a very specific application developed by a small company, could easily be acquired by a company in Europe or in Asia and taken abroad and integrated——

The CHAIRMAN. But not utilized here?

Dr. COOPER. And integrated into a product which would be sold in this country and elsewhere around the world competitively.

Now, if a U.S. company were to create that same technology, then it would be at a disadvantage because it would have had to have spent, say, 20 percent more to acquire such a technology from a small company than an overseas competitor.

Consequently, it would have to charge more for its particular product in relationship to one that was coming from overseas. So, that is the competitive disadvantage.

The CHAIRMAN. Let us get to your point, Mr. Ashley, insofar as the PMSR's. They are readily marketable, are they not?

Mr. ASHLEY. That is correct, Mr. Chairman.

The CHAIRMAN. Yes. Well, I think you make an interesting differentiation there. Would you describe at more length the secondary market in this area and how it operates for the mortgage servicing functions?

Mr. ASHLEY. Mortgage servicing rights are, as I explained in my testimony, a strip of the mortgage interest that is paid to the mortgage servicer for administrative services related to the collection and accounting for that loan over the life of its loan. So, the value of that individual servicing is based on the length of the loan, the life of the loan, and the principal balance of the loan.

Those servicing rights have been readily traded for at least the last 10 years. There is a mega-market for it, approaching $300 billion a year.

The process of that market is that an mortgage originator develops the loan, closes the loan, and would then package those loans with others of similar nature.

And, at some point, the servicing rights of those loans could be sold to another enterprise that was in the servicing business and was interested in buying the servicing rights on that particular package of loans.

The loans themselves are still owned by the purchasers in the secondary market, whether it would be through mortgage-backed securities, Fannie Mae, Freddie Mac, GNMA securities.

It is only the servicing rights that are being transferred—the intangibles, not the actual mortgage loan itself.

The CHAIRMAN. Thank you.

Senator Grassley.

Senator GRASSLEY. Mr. Chairman, I do not have any questions of this panel, although I do have sympathy for the problems expressed by this panel.

My purpose in coming to this meeting was—and I was too late to get here to ask questions of the administration witnesses. I would hope that the record would be left open so that I could submit some questions to the administration for answers in writing.

[The questions appear in the appendix.]

The CHAIRMAN. Senator, the record is left open, and that was stated to the witnesses.

Senator GRASSLEY. All right. Thank you very much.

The CHAIRMAN. Senator Pryor, do you have any questions?

Senator PRYOR. The issue of retroactivity has come up and I think there has been some discussion according to staff today about possibly the retroactive provision or provisions in Chairman Rostenkowski's bill.

Now, has this been thoroughly discussed today? Is there any confusion that we are leaving around about it, or did you wise men and the Chairman resolve the retroactive issue?

The CHAIRMAN. Well, we sure did not resolve it, but we did discuss it at length, Senator.

Mr. BUCKLEY. I would like to make one comment on that area, because I was certainly impressed with the General Counsel of the IRS and Secretary Goldberg's comments that the IRS would look at the period that was still open in the past if you passed a new simplification law, which they strongly urged that you do.

And the IRS would then accept the new law as a guideline and avoid unnecessarily litigation on open years that were consistent with that guideline. To me, that seemed like a very common sense approach.

The $3.2 billion figure that Senator Bentsen mentioned is staggering in its own right. As a former Chief Executive of an almost $2 billion company, I can tell you that I am very suspect of any company that says they are going to choose an option that is going to cost them a lot of tax dollars, unless they have a tax case that looks like it is unwinnable.

Certainly, if I were looking at that kind of a situation, particularly in conference, let us say, some of the great staff people you have here can put in some language to give further guidelines to the IRS. For heaven's sakes, let us discontinue unnecessary controversy, use the new law as a guideline for settling past years, and go on with the prospective bill.

I just cannot see how any retroactivity provision that gives someone an election can be revenue neutral. It is a contradiction in terms.

The CHAIRMAN. Mr. Buckley, I had a hunch when you testified that your experience was not limited to running two trucks.

Mr. BUCKLEY. Thank you. No. I have had a wide career and actually retired from 35 years in the oil business. And, now, I have a small company that a number of heating oil dealers and other independent distributors ask me to consult with them on various government problems.

The CHAIRMAN. Well, this has been very interesting. Gentlemen, it has been most helpful to us. Thank you very much for your testimony. We will be submitting written questions to some of you.

[Whereupon, the hearing was concluded at 11:45 a.m.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF STEVE ASHLEY

Mr. Chairman and Members of the Committee, I am Steve Ashley, CEO of Sibley Mortgage Corporation, located in Rochester, New York, and Vice President of the Mortgage Bankers Association of America. The Mortgage Bankers Association of America (MBA)[1] is the largest trade association for originators and servicers of home mortgages. I am accompanied by Michael Ferrell, Senior Staff Vice President and Legislative Counsel and Larry Parks, Associate Legislative Counsel and Director of Legislation of the MBA. MBA is deeply concerned by the effects of H.R. 4210 on the mortgage lending industry and the homebuying public.

H.R. 4210 would establish an across-the-board 14-year amortization period, by straight-line accounting, for all intangible assets, including mortgage servicing rights. Mortgage servicing rights are assets the value of which is established by the right to future servicing fee income. It is, in effect, a strip of a mortgage loan's interest rate used to compensate the lender for servicing the loan. The vast majority of mortgage servicers amortize servicing rights for book and tax purposes over a seven to ten year period by using an accelerated amortization method. These assets decline in value because of mortgage prepayments, defaults, and the normal pay-down of mortgages. Long years of experience have shown that mortgages on average can be expected to be paid off in a 7–10 year period.

The mortgage servicing industry has developed sophisticated models to evaluate the value of a particular portfolio. The value of mortgage servicing is determined by, among other things, the actual servicing fee on the loans; costs to service the loan; the investors' required yields; state laws relating to foreclosure periods; and the size of related escrow accounts. The proposed legislation, if implemented, would be the equivalent of establishing a depreciation schedule for a building or piece of machinery considerably longer than its true economic life. The Congress should not begin a policy of establishing longer tax lives for established intangible assets that already have accepted tax lives that correlate to the true lives of the underlying assets.

CHARACTERISTICS OF MORTGAGE SERVICING

Mortgage servicing is different from other so called intangible assets. It is marketable, severable, predictable, and its value is quantifiable. These characteristics are usually found only in tangible assets. These characteristics make purchased mortgage servicing rights (PMSR) different from credit card receivables and any other intangibles contained in the August 1991 GAO Report on the Tax Treatment of Intangible Assets.

PMSR is a key component of the established secondary mortgage market. It has a predictable life; a measurable life; and is freely traded. The Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the

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[1] The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of residential and commercial real estate finance. MBA's membership comprises more than 2,200 mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

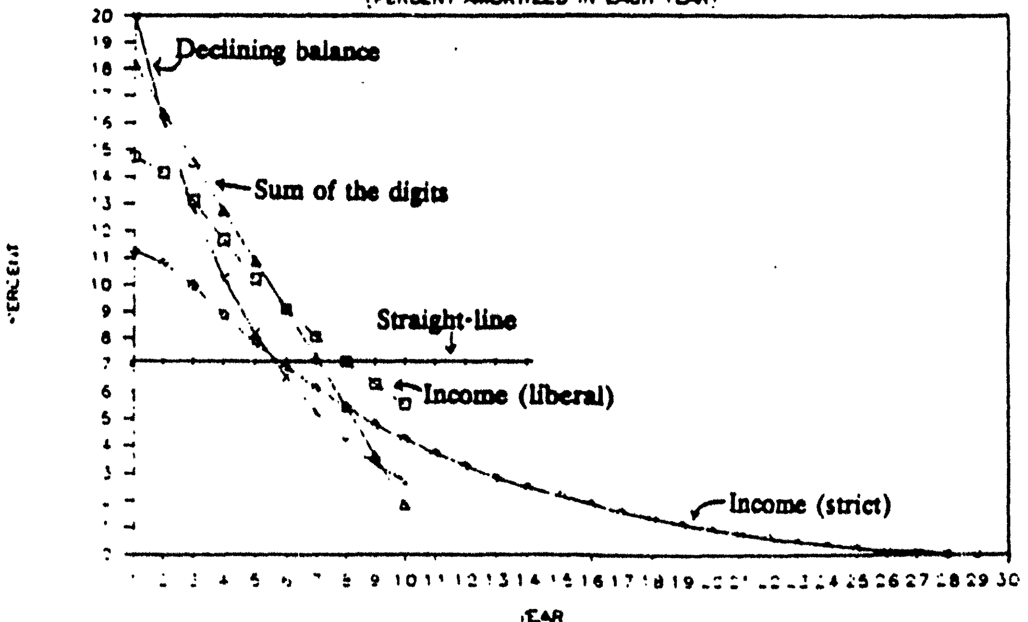
Mortgage Banking Companies; Commercial Banks; Mutual Savings Banks; Savings and Loan Associations; Mortgage Insurance Companies; Life Insurance Companies; Mortgage Brokers; Title Companies; State Housing Agencies; Investment Bankers; Real Estate Investment Trusts

Federal Deposit Insurance Corporation have all deemed PMSR to be the only intangible that is eligible for inclusion in Tier I capital for risk-based and leverage capital purposes. Indeed, the intangibles designation is in many respects inappropriate to purchased mortgage servicing rights.

14-YEAR AMORTIZATION AND THE MORTGAGE LENDING INDUSTRY

Consequences on Industry

Requiring a 14-year tax amortization period for PMSR will reduce the value of virtually all mortgage servicing portfolios. The price that investors would be willing to pay for the asset would be reduced commensurate with the reduction in the tax treatment associated with owning the asset. The net effect would be that holders of mortgage servicing, will have to mark down dramatically the value of their existing asset and should they chose to sell it will realize substantially lower proceeds. The inevitable result will be higher cost to future homebuyers as lenders make-up for the loss in value of the mortgage servicing asset in their existing portfolio.[2]



The amortization change will also impact book and tax accounting. Presently, there is congruity between book and tax accounting. If the amortization of PMSR is changed to a fourteen-year straight-line period, and because most lenders amortize PMSR over a 7–10 year period, there will be little congruity between book and tax accounting in this area in the future. Moreover, if tax amortization periods are elongated, it is likely that companies will lengthen the period over which PMSR is amortized for book purposes creating less reliability in reported financial earnings.

MARKETABILITY

There is an established market for mortgage servicing composed of servicing brokers, buyers and sellers. Mortgage servicing is freely traded at a rate of about $200–$300 billion per year. The IRS has deemed PMSR to be actively traded.[3] Most sellers of mortgage servicing use brokers who are both independent companies and in-

[2] MBA has evaluated the four most commonly used amortization methods for PMSR under current law. They are the double or 200% declining balance over 10 years; the sum of the years digits over. 10 years; the FASB income method over 10 years (liberal interpretation); the FASB income method over the full 30-year life of the mortgage (strict interpretation). These methods were compared with the 14-year amortization method.

[3] In Section 1.167–3 of the IRS regulations, intangible assets may be amortized as long as the assets have a limited useful life the length of which can be determined with reasonable accuracy. During the 1960's and 1970's, the tax court and the federal appellate courts found PMSR to be an intangible asset with a measurable useful life. The precedents remain intact today.

vestment bankers. These brokers act as clearinghouses for servicing. The brokers contact hundreds of potential sellers. The brokers determine the market value of the portfolio. The market value is based largely upon the supply and demand for servicing, the quality of the portfolio, and the location of the mortgages. The brokers, as the sellers' agent, distribute the data base to potential buyers. Offers are made. The broker analyzes the offers and provides the offerings with recommendations to the seller. The seller then decides upon the offers.

This competitive fury would be significantly curtailed if PMSR were required to be amortized over 14 years. The asset would cease to be as marketable and thus fewer firms would want to purchase. This devaluing of mortgage servicing would occur despite the markets' current desire to purchase mortgage servicing rights. The boom in mortgage securitization in the 1980's advanced methodologies and techniques for valuing mortgage servicing. These advances made mortgage servicing a desirable commodity for many companies. Given the ever increasing advancements in technology and the trend toward increased securitization of mortgage servicing, in its currently taxed status, the marketability of servicing should continue to thrive. The 14-year amortization would significantly alter this assumption. The consequence of the change would be the elimination of hundreds of firms who presently compete for servicing. Less competition would result in greater concentration of servicing in the hands of a few. Fewer purchasers of servicing would mean lower prices for servicing and higher prices of mortgages to consumers.

Decline in Value

The 6% decrease in the value of servicing portfolios will have a significant impact on regulated lending institutions. This decline in the value of PMSR would cause a decline in the equity of all firms with PMSR on their balance sheets. For the typical mortgage banking firm, PMSR represents about 13% of assets and equity represents about 12% of assets. The decline in value of mortgage servicing will directly correlate with the decline in equity. Therefore, the 6% decline in PMSR will result in a 6-1/2% decline in the equity of most companies. Ironically, most of the banking reforms have encouraged an increase in equity for lender institutions. Institutions who have purchased mortgage servicing in an attempt to meet regulatory capital guidelines will be unfairly punished by the proposed change in the tax law.

Impact of Change on Consumers

Changing the amortization of PMSR will increase the cost of housing for all homebuyers including low, moderate, and middle income consumers. The effective mortgage interest rates will increase about 50 basis points. On first blush, this increase appears small, but it has significant consequences especially for the typical first-time homebuyer. On a $70,000 mortgage, a typical mortgage for a moderate income borrower, the resulting increase in principal and interest payments would be $75 per year. To meet this additional cost, the borrower will need an additional $500 in yearly income to qualify for the mortgage. That is, if the current amortization remains, a family earning $23,000 could qualify for a $70,000 mortgage. That same family would need $23,500 in income to qualify for the same house, if the 14-year amortization were implemented. This is an unnecessary additional entry barrier for the potential homeowners.

Impact on the Federal Government

Among failed institutions, the RTC has found that the servicing component of the portfolios have been some of the most marketable commodities. Since 1989, the RTC has been able to dispose of $153 billion in mortgage servicing. The RTC estimates that it has $40 billion in mortgage servicing to sell. The servicing has a value of between $400 million and $600 million. If the intangibles title is enacted, the value of the servicing would be reduced by $36 billion. Thus, the government would lose $36 billion in income from mortgage servicing that could help reduce the cost of the S&L bailout.

Impact on the Economy

Currently, banking and thrift regulators allow PMSR to be included in core capital and Tier I capital because purchased mortgage servicing rights are among the best assets an institution can hold. PMSRs have a predictable stream of income and are useful portfolio management tools. Given the trend towards increased securitization of mortgages for single and multifamily housing, banking and thrift regulators have concluded that the marketability of servicing will thrive. These assumptions by the regulators will be erroneous if the tax treatment of mortgage servicing is altered. The reduced marketability of the asset will cause its value to decrease. If PMSR is decreased in value, banks and thrifts will be forced to find new

sources to meet core capital and Tier I capital requirements. Banks and thrifts will lend less and the credit crunch will worsen.

SUMMARY

MBA strongly opposes extending the amortizable life of mortgage servicing. Including PMSR into the intangibles title would add unnecessary costs to consumers as they attempt to buy a home; fundamentally alter an existing competitive market; add to the cost of the thrift cleanup; and increase the tax burden on the mortgage lending industry. In balancing the need for tax simplicity with the additional costs and less efficiency in mortgage lending, we believe everyone would be better served—including the Federal government—if mortgage servicing rights should be excluded from the intangibles title.

Mr. Chairman, MBA appreciates the opportunity to testify on this most important issue to the homebuying public and the real estate finance industry. We would be glad to respond to any questions or comments the Committee may have.

PREPARED STATEMENT OF WILLIE L. BAKER, JR.

Chairman Bentsen and Members of the Committee, the United Food and Commercial Workers International Union represents roughly 1.2 million U.S. workers, three-quarters of whom work in the retail and food industries. These industries were hotbeds of takeover and merger activity during the 1980s. Even though activity has cooled down to some extent, in many instances, our members continue to suffer the effects of that era.

We are deeply concerned about and opposed to the current proposal to permit the amortization of intangible assets for tax purposes embodied in H.R. 3035, and included with modification in H.R. 4210, the Senate-House tax bill recently vetoed by the President.

By including goodwill and going concern value along with virtually any and all intangible assets a company can claim as expenses, we believe such legislation would introduce a tax subsidy for future takeover activity, that did not exist in the 1980s. There is a serious possibility that ill-considered action by Government, could set the stage for a new round of the same takeover activity that has done so much damage to our members, to their employers, and to the communities in which they live. Other knowledgeable observers share our belief that the industries in which our members work, will be the focal point of increased numbers of mergers and acquisitions, underwritten by the legislation being discussed today. To us, that spells even more pain and suffering.

Whether or not tax legislation is acted on in this session of Congress, we believe the pressure to do something will continue into 1993. Even the most optimistic forecasters believe that when and if recession changes to recovery, that recovery will be slow and long drawn out. Demands will be made on Congress to use tax policy as an economic stimulant, since that seems to be the only politically acceptable tool, outside the Federal Reserve Board. When and if such tax legislation is being considered, this proposal in one form or another, will undoubtedly be introduced into the package. The mountain of litigation and conflicting court rulings on the issue of amortization of intangibles will not disappear unless and until Congress legislates in this area. We therefore believe that this legislation will indeed have to be dealt with in the near future. But there are undoubtedly better ways to accomplish the necessary goals than what is being offered.

As it is written, H.R. 3035 is totally unacceptable to us. Such tax policy creates economic incentives for destructive and wasteful behavior at a time when our society cries out for productive investment in new products and services and when working people are desperately overdue, not for further assaults on their wages, benefits and working conditions, but for meaningful improvement. In addition, if Congress actually passes such legislation, it will send a message to business and to the legal profession, that one way to get Congress to act in their favor is to create such a barrage of complaint and challenge, that regardless of the merits, Congress will be forced to act just to "make the problem go away." This introduces yet another incentive to wasteful activity.

How is H.R. 3035 related to takeovers? Assistant Treasury Secretary Gideon succinctly summarized the issue in his October 2, 1991 testimony before the House Ways and Means Committee: ". . . disputes persist concerning whether an intangible asset acquired in the purchase of an ongoing business is within Class III and amortizable, or constitutes goodwill or going concern value and, therefore, is within Class IV and nonamortizable." Many observers claim that the language of the Tax Reform Act of 1986, by requiring the use of the residual method for calculating goodwill,

affirmatively encouraged companies to allocate as much purchased value as possible to assets other than goodwill. Whether or not one accepts that interpretation of the Act's language, it is indisputably the case that the number of challenges to IRS rulings in this area escalated in the latter part of the 1980s.

In the "normal course of business," the amortization of intangible assets might be viewed simply as a technical issue. But these IRS challenges and the ensuing litigation, which have both prompted and justified H.R. 3035, are intimately related to the escalation of takeover activity during the period, and the worsening quality of the deals. An appropriate legislative response must be fully cognizant of this relationship.

It is not a coincidence that Congress is being forced to address this issue now. According to the General Accounting Office, "Treasury regulations covering the treatment of goodwill have not changed significantly since 1927."[1] Yet the total value of intangible assets reported to the IRS by corporations grew from $45 billion to $262, billion in 1987. According to the GAO, "the increase generally reflected the growth in merger and acquisition activity during the period. As the reported values increased, increases in total amortization deductions for tax purposes were also reported."[2]

But it wasn't simply ordinary merger and acquisition activity. In the 1980s' takeover deals, firms were acquired for enormous multiples, thereby inflating the amounts that had to be spread over Class III assets. In the early 1980s acquisitions were made at 4 or 5 times EBITDA (earnings before interest, taxes, depreciation and amortization). At the peek, some deals were being done at 9 or more times earnings. A recent study by Steven N. Kaplan and Jeremy C. Stein,[3] found significant deterioration in the quality of buyout deals during the course of the 1980s. Transactions done in the second half of the decade were substantially riskier, with poorer financial performance, than those of the early 1980s. Among other detailed findings, they note that "the ratio of buyout prices to company cash flows increase significantly over time . . . and leverage ratios increase over time." (p.3) While the authors to some extent play down the role of price, by pointing out that stock market prices relative to cash flow showed the same increasing trend, they overlook a fundamental difference in buyout price versus stock price. Individual shares of a firm are traded daily, without any significant impact on the operating performance or financial condition of the firm. In a buyout or takeover, all the shares are sold at one time, and a substantial premium over the market price is a typical characteristic of these transactions. There is inevitably an impact on the subsequent performance of the firm.

In order to prevent or forestall the financial collapse of inherently untenable deals concluded in the 1980s, clever tax lawyers in effect, have sought to shore up shaky enterprises at the expense of the U.S. Treasury, and other taxpayers. They have invented an enormous range of new kinds of intangible assets, which IRS regulations permit them to try to prove are justifiably amortizable. This has even been recognized by the business press: the *Financial Times* of London observed that during the 1980s, as the premiums paid in acquisitions increased so did the incentives for creativity by tax advisers. Acquirers did not accept fatalistically that the large premiums they paid had to be additional goodwill. Instead, the assets of targets were closely scrutinized to ensure that no possible depreciable or amortizable asset was overlooked."[4] Any legislative remedy must shut down this game.

If, as under the proposed legislation, firms know that all goodwill is amortizable, **they can pay even higher prices for acquired films than they would have without this tax provision.** This is a tax incentive for creating weaker companies.

The evidence is clear and unambiguous. According to John E. Heinbock, a securities analyst at Goldman Sachs & Co., "the amount paid for the deal originally has become a central factor . . . in assessing the potential success of the whole venture. (In the high cost deals) the vast majority of cash flow (must) be directed into debt service, with very little left over even for maintenance spending."[5] William Lang (Brookings Institution) and David Ravenscraft (University of North Carolina) found a marked difference in the results of the higher-priced deals done in the second half of the 1980s as compared to the more modest deals of the earlier years: "LBOs done

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[1] *Issues and policy proposals regarding tax treatment of Intangible assets*, General Accounting Office, Report to the Joint Committee on Taxation, August, 1991, p.16. Hereafter *GAO*.

[2] GAO, p.10

[3] Steven N.. Kaplan and Jeremy C. Stein, "The Evolution of Buyout Pricing and Financial Structure in the 1980s," draft provided by authors, February, 1992.

[4] Leo Herzel and William A. Schmalz, "Tax bill in US Congress Seems to Promote Takeovers," *Financial Times*, January 30, 1992, p. 38.

[5] David Merrefield, "LBO Success Hinges on the Purchase Price," *Supermarket News*, March 16, 1992.

in the last part of the decade shouldn't have been. The improvement in operating efficiency (shown by some of the early deals) vanished."[6] Stephen Roach, senior economist at Morgan Stanley, believes that the takeovers of the 1980s "did nothing to rejuvenate the nation's competitive position through capital formation."[7] One observer who studied 41 of Fortune's "Deals of the Year" for the years between 1985 and 1990 and found half to be in poor or failing health, including bankruptcy, concluded that "The greatest deal killer of the Eighties was the one that has always been the leading cause of corporate death and investor loss—overpaying."[8]

At the moment, takeover activity is relatively quiet. But pressure is building within the deal-making community. "If the deductibility of goodwill they are discussing goes through, it will spark some business," according to David Wittig, co-head of mergers and acquisitions at Salomon Brothers.[9] A director of the McKinsey & Co. management consulting firm estimates that "a fifth of Standard & Poor's industrial companies are potential takeover targets right now because of their lackluster rates of return."[10]

As in the 1980s, our members' livelihoods will once again be put on the line because food and retail companies have particular characteristics that lend themselves to takeover, merger and divestiture activity. In early December of last year, Bob Chapman, a vice-president of arbitrage at County NatWest Securities, commented on the likely results of passage of H.R. 3035: 1t would be a huge boon. I would say you would see a billion-dollar deal announced in weeks if it goes through . . . The takeover values of food companies would go up 20 percent overnight."[11] According to *Investment Dealers' Digest*, "many analysts are saying that food companies will be leading candidates for acquisitions should H.R. 3035 pass. They claim that such companies with outstanding brand names and franchises will benefit greatly because so much goodwill will be generated if they are sold."[12] As an example, at this very moment, the principal beneficiaries of the trust that holds the stock of the George A. Hormel Company, employer of 3000 UFCW members, are pressuring the trust to sell the stock to the public—a sure preamble to takeover. These millionaires by inheritance, would get an additional unearned premium for their shares, thanks to the tax system, if this legislation were in effect when and if the company were sold.

Even the strongest deals of the 1980s required the sale of assets of the acquired or restructured company to provide a quick infusion of cash to pay off the highest cost, shortest term debt (frequently bridge loans from banks). Between 1986 and 1988, as a result of Kohlberg, Kravis & Roberts' leveraged buyout of Safeway, 7000 workers represented by our union lost their jobs outright when the Dallas division was sold off, 4–5000 were disemployed when the Salt Lake City division was shut down, nearly 1000 people lost their jobs when individual stores in Washington, DC, Baltimore and Maryland's Eastern Shore were sold off, and another 20,000 took very substantial cuts in wages and benefits when the Little Rock, AR, Kansas City, MO, Oklahoma and Houston, TX divisions were sold in further leveraged buyout deals. With the single exception of Oklahoma, all those Safeway "spin-offs" are in serious financial trouble today, with some in bankruptcy reorganization.

When Kohlberg, Kravis & Roberts did a leveraged buyout of Stop & Shop Companies, 5000 UFCW members who worked at Stop & Shop Bradlees discount stores, lost their jobs when the stores were closed and sold off piecemeal. When Grand Union was taken private in an LBO, its Colonial/Big Star division in the Carolinas was sold off: 3000 workers represented by our union, lost their jobs. When Lucky Stores restructured itself to escape a hostile takeover by Asher Edelman, the company first sold its Gemco division; 5000 members lost their jobs when Lucky's Gemco stores were sold. Another 2000 took substantial cuts when Lucky spunoff its Eagle Food Stores division. The various parts of the former Armour Company and Beatrice Foods have been through so many ownership changes over the past ten years, with accompanying buying and selling of plants, it is almost impossible for us to keep track of the ultimate job loss.

It is no exaggeration to say that the prospect and consequence of asset sales by food and retail companies continues to be an everyday concern at our union. The

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[6] Quoted in Edmund Falktermayer, "The Deal Decade: Verdict on the '80s," *Fortune*, August 26, 1991. Hereafter *Fortune*.

[7] *Fortune*

[8] Gregory Smith in *Fortune*.

[9] Anthony Baldo, "Tax simplification bill may not be a boon to M&A," *Investment Dealers' Digest*, December 23, 1991.

[10] *Fortune*

[11] Quoted in Floyd Norris, "A Likely Tax Bill Provision That Would Aid Takeovers," *New York Times*, December 4, 1991.

[12] *IDD*, December 23, 1991.

members of the United Food and Commercial Workers International Union do not want a replay of the 1980s. It is especially troubling to think that this could happen as a result, not so much of Wall Street mania, but as a result of deliberate government action. But that is what H.R. 3035 offers us.

What about the arguments in favor of amortizing goodwill and other intangible assets without known "useful lives?"

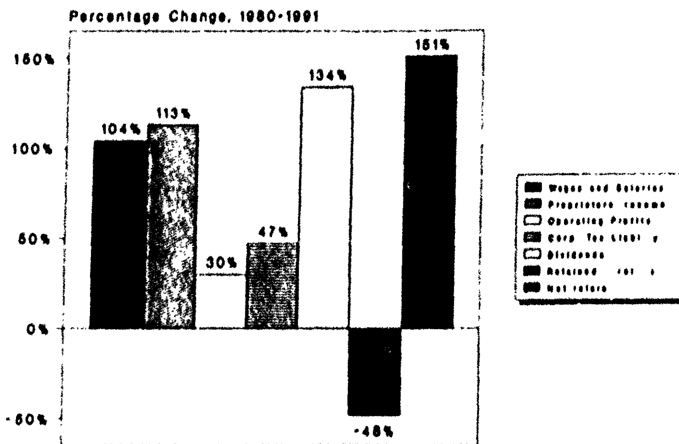
It is argued that something needs to be done to end the litigation in this area and to resolve pending disputes that the courts are unable to handle on a consistent basis—and this may be so. But where did the litigation come from? To us, it looks as though the same corporate lawyers who put together these questionable deals, also exploited and widened every loophole they could find and/or create in the existing body of tax law. They have created a mountain of litigation in an attempt to force a ruling in their favor, if not by the IRS, then by the courts. And if not by the courts, then by Congress. And now Congress is considering making real this self-fulfilling prophecy.

But if tax simplification were the principal goal, there would be another equally satisfactory solution to the problem of amortization of intangibles: don't allow any of it. This solution would increase revenue, reduce audit and litigation expenditures and handsomely serve the goal of tax simplification. But clearly, it is also a non-starter.

Another consideration is the equity consequences of the proposal. Virtually all the discussion of this issue has confined itself to equity between different classes of assets. There has been scant discussion of the impact of this proposal on the one hand, on the income and tax status of working Americans who will be hurt by the larger economic and incentive effects of the bill, and on the other hand, on the corporate taxpayers and investors who will be the beneficiaries.

As illustrated in Figure 1, during the 1980s, the wage and salary earnings of ordinary citizens stagnated. So did corporate retained earnings and the tax revenue generated by corporate profits. Interest income skyrocketed, largely as a result of the leveraging of American business through the takeover, merger and acquisition activity we have discussed.

Growth of Interest and Dividend Income
Overshadows All Other Types of Income in 1980s



Source: U.S. Department of Commerce Figure 1.

This country cannot grow and prosper if it continues to curb the incomes of the vast mass of the population while inflating the incomes of those who profit from financial manipulation. And what will we have done to the principles of the 1986 Tax Reform Act, if we actually use the tax system to exacerbate this income transfer?

Another justification for this bill has been its alleged revenue-neutrality. We are told that while some will win and some will lose, the uniform 14-year amortization period mathematically produces revenue neutrality. But to us, offsetting irrationalities do not make sensible policy. Rewarding inventive litigators who put their brainpower to work creating alleged intangible assets such as "morgues," or "assembled workforce" (who ever bought an on-going business without an assembled

workforce?) sends the wrong message about the purpose and goals of our tax system.[13]

Another line of argument that has been put forward is that because financial accounting rules require the amortization of goodwill, recognizing it as a "wasting" asset, tax rules should do so as well.[14] This line of argument effectively makes government tax policy subservient to accounting rules developed for entirely other purposes by the Financial Accounting Standards Board. Public policy decisions in a democratic society must answer to a higher and far more complex set of considerations than a private sector board with a narrowly defined professional purpose, such as the FASB. Public policy recognizes that not all forms of investment or earnings should be treated the same way—just look at the differing ways the tax code has handled real estate investment. Goodwill is even more problematic. Not only does it have no measurable useful life, but in the context of a takeover, its value can increase enormously in just a few short weeks, for reasons having nothing to do with the operations of the firm. It is a pure artifact of the market.

We can see that there are some classes of assets that are now considered to be "intangibles" that are in fact somewhat close to tangible assets in that they are often bought and sold even with no acquisitions and divestitures being involved. That is, independent markets exist for some of these goods and their market prices and "useful lives" are ascertainable. It should be possible to identify a certain **very limited** number of assets that have these characteristics, that can **unambiguously** pass the test used for classifying "tangible" assets. These could be permitted specified amortization lives by law, in the same way that different classes of tangibles assets are now assigned fixed amortization lives. Everything else would unambiguously be ineligible for amortization. The legislation that Congress writes must clearly limit the Internal Revenue Service's ability to make discretionary rulings in this area. Congress must enact strong and explicit language to curtail the clever reallocation of goodwill or going concern value over an endless range of invented assets. In so doing, it would give the IRS and corporate taxpayers clear rules, and it would close the door on tax lawyer ingenuity. Tax considerations would play less of a role in takeover and acquisition decisions, and the incentive effect would be removed.

As you consider this proposal, we ask that you tighten and clarify the rules and write them in such a way that the members of the UFCW and the millions more non-union workers who are even more vulnerable to harm, are spared future pain and suffering of newly tax-subsidized acquisition and divestiture activity. We believe this requires a definitive, clear and conservative approach to the issue.

PREPARED STATEMENT OF WILLIAM P. BENAC

INTRODUCTION

Good morning. I am William P. Benac, Treasurer of Electronic Data Systems, headquartered in Dallas, Texas. EDS provides software-based information technology services to customers in a broad range of industries, including health care, financial services, insurance, manufacturing, communications and energy. EDS employs more than 70,000 people in more than 30 countries around the world and had 1991 revenues of more than $7 Billion.

I am here today on behalf of the Information Technology Association of America. ITAA is the trade association of this nation's computer software and services industry, whose more than 36,000 companies provide government and corporate America with business application and systems software for mainframe, midrange, and personal computers; custom and contract software programming services; information systems integration services; and information processing services. In 1990, the last year for which figures are available, U.S. information technology services companies generated over $100 Billion in revenue, an increase of 12% over the previous year, and employed over a million people nationwide. The United States leads the world in information technology and even during this period of economic downturn, the

[13] In testimony before the House Ways and Means Committee in October, 1991, Internal Revenue Service Commission Fred T. Goldberg, Jr. presented a list of 175 "Taxpayer Claimed Intangible Assets." His testimony and this list is an eloquent illustration of the waste of resources that has been directed at the goal of transferring income that would otherwise go to the Treasury back to the firms who got caught up in ill-advised acquisition and divestiture deals.

[14] "Allowing tax deductions for the cost of all wasting intangible assets consumed by a business would improve the measurement of income and treat all forms of investment more equitably,." Jennie Stathis, Director of Tax Policy and Administration Issues, GAO, House Ways and Means Committee Hearing, October 2, 1991.

U.S. information technology industry is contributing positively to the nation's economy and balance of trade. Computer software, the subject of my presentation, is critical to the information technology industry and to American industry generally. While steam powered the America of the late 19th Century, computer software, the digitized intelligence which controls banking, manufacturing, and office operations, is the engine which drives business at the close of the 20th Century.

ITAA applauds the goal of tax simplification, abating the controversies between taxpayers and government over the proper tax accounting treatment of intangible assets. At the same time, however, the success of the U.S. information technology industry depends on those well-established rules that have taken into account the business and technological realities of computer software. The information technology industry has prospered in this climate. We are concerned that the pending intangibles legislation, even as amended in H.R. 4210, does not comport with the technical and business realities of the software industry. This legislation will impede the ability of U.S. information technology companies to compete in world markets because it will effectively raise the cost of acquiring computer software by 10 to 15 percent. Moreover, the disparity between U.S. and foreign tax principles will make it less expensive for foreign interests to acquire U.S. software technology than for their U.S. counterparts. The pending intangibles tax legislation thus achieves its otherwise laudable goals at the expense of one of America's premier industries.

Accordingly, ITAA urges:

- that the present tax accounting rules for developing and acquiring computer software be retained and that computer software not be swept up in the proposed 14-year amortization rule, or
- if computer software is to be covered by intangibles tax legislation, then in addition to that computer software already addressed in H.R. 4210, other software should also be excluded from the proposed 14-year amortization rule where it is part of a trade or business acquisition and the primary object of the trade or business acquisition is the software technology as such.

COMPUTER SOFTWARE DIFFERS SIGNIFICANTLY FROM THE OTHER INTANGIBLES UNDER CONSIDERATION

The principal House bill in this regard, H.R. 3035, was introduced to abate the controversies arising under current law with respect to the acquisition of intangible assets.[1] Of particular concern, and contention, was the tax accounting treatment of business goodwill, going concern value, covenants not to compete, and workforce in place, in the context of trade or business acquisitions. In contrast to these customer-based intangibles, however, computer software is capable of reasonable valuation and has a relatively short commercial life, no matter how acquired.

Computer software is traded in the marketplace every day. Where software is acquired under a license agreement, its cost for the end-user is apparent. Even in the business acquisition context, the cost of computer software is reasonably ascertainable. Methodologies have been developed for valuing software using a Cost basis.[2]

Even more significant, the lifecycle of computer software is far shorter than 14 years. The popular spreadsheet program "1-2-3," from Lotus Development Corporation, was introduced in 1983. Since then, there have been five new versions of that program, the latest being released in August 1991. Likewise, Microsoft Corporation's word processing program, "Word," was introduced in 1983 and has since seen four new versions and three major upgrades. Even the complex mainframe software used to power sophisticated banking or airline reservation systems is upgraded and enhanced frequently because of advances in both software and hardware technology. At EDS, for example, the computers at our large information processing centers are

[1] Under current law, a taxpayer may amortize the cost of intangible property used in a trade or business or held for the production of income, so long as the property has a reasonably determinable, limited useful life. According to the explanation accompanying H.R. 3035, IRS/taxpayer controversies have centered on: (1) whether an amortizable intangible asset exists, (2) whether, in a trade or business acquisition, the value of the intangible asset is reasonably determinable, and (3) the appropriate cost recovery method and period.

[2] The Constructive Cost Model or COCOMO is one of several methods generally recognized by appraisers and industry as providing a consistent and reliable measurement of software value from a cost approach. Generally speaking, COCOMO is used to determine the replacement cost of software by estimating the man-months needed to recreate the software and involves an examination of the program code and projected date of obsolescence. In discussions with the Joint Taxation Committee staff, ITAA has attempted to avoid altogether the question of software valuation by proposing that in the business acquisition context, 75% of all acquired intangible assets be regarded as computer software if at least 75% of the revenue of the acquired business is software-related.

typically upgraded as often as every 18 months, meaning that the software must also be changed and upgraded. Software technology throughout all of American business is evolving rapidly, in response to changes in law and regulation, customer demands, and technology. The proposed 14-year amortization period will mean that businesses acquiring computer software will still be writing off the acquisition costs long after they have stopped using the software due to technological obsolescence. Tax accounting in most cases will be anything but simplified.

H.R. 4210 OFFERS ONLY PARTIAL RELIEF

Recognizing at least some of the difficulties inherent in H.R. 3035, the House took a modified stance in H.R. 4210. That legislation proposed to exclude from the 14-year amortization rule software that is acquired outside the context of a business acquisition. However, computer software acquired within the context of a trade or business acquisition would be excluded only if it were: (1) readily available for purchase by the general public, (2) subject to a nonexclusive license, and (3) had not been substantially modified. In other words, "business acquisition" software would be governed by the 14-year rule where the purchaser acquires ownership rights in the software as distinguished from the mere right to use copies. Thus, if a software or software services company chose to acquire software technology by purchasing another software or software services company, the cost of the purchased software would have to be written off over 14 years.[3]

Although H.R. 4210 is a step in the right direction, it fails to recognize that corporate acquisition is another primary vehicle by which software technology can change hands.

Corporate acquisition, rather than internal development, is often the most cost-effective and timely means of acquiring software technology. This "business acquisition" software is no less subject to the pressures of technological obsolescence than that transferred pursuant to nonexclusive license through retail channels. The net effect, then, of H.R. 4210 would be to provide different write-off periods for the same type of technology depending solely upon the method of technology transfer.

THE UNITED STATES' MAJOR TRADING PARTNERS EXTEND FAVORABLE TAX ACCOUNTING TREATMENT TO COMPUTER SOFTWARE

The United States is the recognized world leader in software technology; however, that status is not secure, several nations having set their sights on achieving world superiority in this area. These nations, recognizing the strategic and competitive importance of software, have established tax policies specifically designed to enhance their growing domestic software industries. Canada, France, Germany, Japan, and the United Kingdom, to name a few, allow the amortization of software acquisition costs over five years or less. Japan, for whom international leadership in information technology is a national objective, allows a write-off over five years. Canada permits the immediate write-off of applications software and a 30% per year write-off of systems software costs.

A major effect, albeit unintended, of the proposed intangibles tax legislation, even after amendment by H.R. 4210, is that foreign purchasers who seek to acquire software technology through corporate acquisition will have a comparative cost advantage over their U.S. counterparts because foreign taxpayers will be able to write off their software acquisition costs over five years or less. This raises the specter that cutting-edge U.S. software technology, often developed by small, undercapitalized firms, will be more cheaply acquired by foreign interests and then licensed back for use in the U.S.

EXISTING TAX ACCOUNTING PRINCIPLES HAVE SERVED THE INDUSTRY WELL

Since 1969 the Internal Revenue Service has required that the cost of software purchased separately from computer hardware be amortized ratably over five years or such shorter period as the taxpayer can establish as appropriate.[4] After more than 20 years of experience, there is no question that, from the industry's perspective, these rules have worked well and make sense from a technological and business viewpoint.

Moreover, the origin of the major IRS/taxpayer controversies that the intangibles legislation was designed to address has not been computer software. The report of the General Accounting Office, issued in August, 1991, indicates that only 6% of

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[3] The House also proposed in H.R. 4210 that the cost of software excluded from the 14-year rule be amortized over 3 years.

[4] Revenue Procedure 69–21 is the principle rule governing the tax accounting treatment of computer software.

cases then in litigation were technology-related. There is no indication how many of these, if any, arise from computer software transactions.

ITAA's first preference, then, is the retention of existing tax accounting rules under Revenue Procedure 69–21. The principles of 69–21 make as much technical and business sense today as they did 23 years ago.

In response to H.R. 3035 and H.R. 4210, ITAA has urged that the costs of software technology acquired through business acquisition be treated the same as the costs of publicly available software acquired through nonexclusive license. If, however, full exemption from the 14-year rule is not accorded to all software acquired in a trade or business acquisition, then ITAA urges that at a minimum an exemption should apply where the principal object of a trade or business acquisition is the software technology as such. In these cases, generally little goodwill or other customer-based intangibles are at stake. Without an exclusion for this "business acquisition" software, acquirors will face the prospect of higher acquisition costs than their foreign counterparts as well as the necessity of writing off software costs long after the acquired technology has become obsolete. ITAA has submitted statutory language in this regard to this Committee and to the Ways and Means Committee and remains anxious to work with you and your staff to find an equitable solution to the problems raised by H.R. 4210.

CONCLUSION

ITAA and I thank you for the opportunity to testify before you today. Computer software is nothing less than a strategic national asset—a major area in which the United States leads the world. But that leadership is under challenge by other nations that have set their sights on achieving superiority in information technology and who, to achieve these ends, afford computer software development and acquisition tax treatment that is identical to or more favorable than the treatment that we in the United States have used successfully for more than 20 years. Computer software is also a rapidly advancing technology in which the innovations of today are quickly superseded. Quite simply, computer software does not lend itself to the 14-year tax accounting treatment under consideration by this Committee. We urge you to retain the present tax accounting treatment for software, as defined in Revenue Procedure 69–21, providing a basis for both sound tax policy and sound trade policy. If existing tax accounting rules are modified, we urge you not to undermine those business transactions in which software is the principal object of the transaction.

[SUBMITTED BY SENATOR LLOYD BENTSEN]

[JOINT COMMITTEE PRINT]

PRESENT LAW AND PROPOSALS RELATING TO THE FEDERAL INCOME TAX TREATMENT OF THE COST OF ACQUIRING GOODWILL AND CERTAIN OTHER INTANGIBLES

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON APRIL 28, 1992

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on April 28, 1992, to consider the Federal income tax treatment of the cost of acquiring goodwill and certain other intangible assets. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the present-law tax rules, a description of two legislative proposals that would modify the present-law tax rules, and a discussion of issues relating to the present-law tax rules and the two legislative proposals.

Part I of the pamphlet contains a summary of present law and the two legislative proposals. Part II provides a more detailed description of the present-law tax rules and background relating to the treatment of the cost of acquiring intangible assets. Part III provides a more detailed description of the two legislative proposals: (1) section 4501 of H.R. 4210, as passed by Congress on March 20, 1992, and vetoed by the President; and (2) S. 1245, as introduced by Senators Daschle and Symms on June 6, 1991. Part IV provides a discussion of issues relating to the present-law tax rules and the two legislative proposals.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Present Law and Proposals Relating to the Federal Income Tax Treatment of the Cost of Acquiring Goodwill and Certain Other Intangibles* (JCS-9-92), April 27, 1992.

I. SUMMARY

Present law

In determining taxable income for Federal income tax purposes, taxpayers are allowed depreciation deductions for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or that is held for the production of income. Under Treasury Department regulations, no depreciation deductions are allowed with respect to intangible property unless the intangible property has a limited useful life that may be determined with reasonable accuracy. In addition, under the same Treasury Department regulations, no depreciation deductions are allowed with respect to goodwill or going concern value.

Numerous court decisions and Internal Revenue Service pronouncements have addressed whether depreciation deductions are allowed with respect to intangible property. In general, a taxpayer must establish that the intangible property is distinguishable from goodwill or going concern value and that the intangible property has a limited useful life that is determinable with reasonable accuracy. Because this is essentially a factual determination, different results have often been reached in different cases with respect to the same or similar types of intangible property.

H.R. 4210

Section 4501 of H.R. 4210 [2] would allow an amortization deduction with respect to the capitalized costs of goodwill, going concern value, and certain other intangible property that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction would be determined by amortizing the adjusted basis of the intangible ratably over a 14-year period.

Section 4501 of H.R. 4210 generally would apply to specifically defined intangible property whether acquired as part of the acquisition of a trade or business or as a single pre-existing asset. The bill would not change the Federal income tax treatment of self-created intangible property, such as goodwill that is created through advertising or other similar expenditures.

The provision generally would apply to property acquired after the date of enactment. A taxpayer, however, would be allowed to elect to apply a version of the provision to either (1) all property

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[2] H.R. 4210, the "Tax Fairness and Economic Growth Act of 1992," was passed by Congress on March 20, 1992, and was vetoed by the President. See H. Rept. No. 102-461 (Conference Report), March 20, 1992, pp. 190-200 and 545-566. Section 4501 of H.R. 4210 was derived from H.R. 3035. For a description of H.R. 3035 and related House bills, see Joint Committee on Taxation, *Description of Proposals Relating to the Federal Income Tax Treatment of Certain Intangible Property (H.R. 3035, H.R. 1456, and H.R. 563)* (JCS-14-91), September 30, 1991.

acquired after July 25, 1991, or (2) all property acquired in certain taxable years for which the statute of limitations for the assessment of tax has not expired.

S. 1245

S. 1245, as introduced by Senators Daschle and Symms on June 6, 1991, would amend section 167 of the Internal Revenue Code to provide that if a taxpayer demonstrates through any reasonable method that (1) customer base, market share, or any other similar intangible item has an ascertainable value that is separate and distinct from other assets (including goodwill and going concern value) acquired as part of the same transaction, and (2) the intangible item has a limited useful life which can be reasonably estimated, then the basis of the intangible shall be amortized over such useful life.

In addition, S. 1245 would grant the Treasury Department the authority to promulgate regulations establishing safe harbor useful lives for specific classes of customer base, market share, or other similar intangible items which are generally consistent with the actual useful lives for the items within such classes. In addition, the Treasury Department would be authorized to promulgate regulations concerning the manner in which such intangible items may be valued separately and distinctly from other assets (including goodwill and going concern value).

S. 1245 would apply to all open taxable years (i.e., all taxable years for which the statute of limitations has not expired).

II. BACKGROUND AND PRESENT LAW

In general

Under section 167 of the Internal Revenue Code, taxpayers are allowed depreciation deductions for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or that is held for the production of income. Under Treasury Department regulations, no depreciation deductions are allowed with respect to intangible property unless the intangible property has a limited useful life that may be determined with reasonable accuracy.[3] In addition, under the same Treasury Department regulations, no depreciation deductions are allowed with respect to goodwill.

Thus, in order for depreciation or amortization [4] deductions to be allowed for Federal income tax purposes with respect to intangible property, a taxpayer generally must establish that the property is distinguishable from goodwill and that the property has a limited useful life that is determinable with reasonable accuracy. Numerous court decisions and Internal Revenue Service (IRS) pronouncements have addressed whether these requirements have been satisfied with respect to different types of intangible property. The determination whether depreciation deductions are allowed with respect to intangible property is dependent on all the facts and circumstances. In certain situations, however, the IRS and some courts have suggested that certain results should be considered a matter of law. Often, different results have been reached in different cases with respect to the same or similar types of intangible property.

Issues regarding the amortization of intangible assets frequently arise in the context of the acquisition of a business enterprise. If the price paid to acquire a trade or business exceeds the value of the tangible assets of the trade or business, the purchaser generally must allocate such excess either to (1) goodwill or going concern value, which are not depreciable or amortizable for Federal income

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[3] Treas. Reg. sec. 1.167(a)-3 provides that:

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

[4] The deductions allowed for the exhaustion, wear and tear, and obsolescence of intangible property that is used in a trade or business or that is held for the production of income are often referred to as amortization deductions.

tax purposes, or (2) other intangible assets, which may be depreciable or amortizable for Federal income tax purposes.[5]

The following discussion illustrates some of the issues and inconsistencies that arise under present law.

Treatment of certain customer-based intangibles

Taxpayers that have acquired a trade or business have often allocated a portion of the purchase price to customer lists, subscription lists, client records, and other similar intangible assets that represent the customer base of the trade or business. A recurring issue for Federal income tax purposes has been whether a value and life for such intangible assets can be identified that is separate and distinct from goodwill, which generally has been defined as "the expectancy that old customers will resort to the old place" [6] or "the expectancy of continued patronage, for whatever reason." [7]

In a number of cases decided prior to 1973, the courts generally held that customer lists and other similar customer-based intangibles are "related to" or "in the nature of" goodwill and, consequently, no depreciation or amortization deductions are allowed with respect to such assets. In many of these cases, the IRS successfully argued that such customer-based intangibles are "mass assets," the value of which may fluctuate as particular customers are lost and others replace them. These mass assets were considered to provide an inexhaustible benefit and have an indefinite useful life.

For example, in *Golden State Towel and Linen Service, Ltd. v. United States*,[8] the Court of Claims denied a depreciation or loss deduction with respect to a customer list that was acquired in connection with the purchase of the assets of a linen business. The court held that a terminable-at-will customer list is an indivisible asset that is indistinguishable from goodwill. The court found that while the list is subject to temporary attrition as well as expansion due to the departure of old customers and the addition of new customers, no deduction is allowed for Federal income tax purposes for the normal turnover of customers.[9]

In 1973, however, the Fifth Circuit Court of Appeals in *Houston Chronicle Publishing Company v. United States* [10] held that the "mass asset" theory does not preclude depreciation or amortization deductions with respect to customer-based intangibles. In *Houston*

[5] See section 1060 of the Code and the regulations thereunder which provide rules for the allocation of the purchase price among assets in the case of certain acquisitions occurring after May 6, 1986.

[6] *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963).

[7] *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). See, also, *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3rd Cir. 1991), *cert. granted*, April 6, 1992.

[8] 373 F.2d 938 (Ct. Cl. 1967).

[9] See, also, *Danville Press, Inc. v. Commissioner*, 1 B.T.A. 1171 (1925) (no depreciation deductions allowed with respect to newspaper subscribers); *Boe v. Commissioner*, 35 T.C. 720 (1961), *aff'd* 307 F.2d 339 (9th Cir. 1962) (no depreciation or loss deductions allowed with respect to medical service contracts); *Westinghouse Broadcasting Co. v. Commissioner*, 36 T.C. 912 (1961) (no depreciation deductions allowed with respect to spot advertising contracts); *Scalish v. Commissioner*, 21 T.C.M. 260 (1962) (no depreciation deductions allowed with respect to cigarette vending machine location leases); *Thoms v. Commissioner*, 50 T.C. 247 (1968) (no depreciation deductions allowed with respect to insurance expirations); and *Marsh & McLennan, Inc. v. Commissioner*, 51 T.C. 56 (1968), *aff'd* 420 F.2d 667 (3rd Cir. 1970) (same). But, see, *Seaboard Finance Co. v. Commissioner*, 367 F.2d 646 (9th Cir. 1966) (depreciation deductions allowed with respect to favorable loan contracts).

[10] 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

Chronicle, the taxpayer acquired lists of newspaper subscribers in connection with the acquisition of the tangible assets of a newspaper publishing company. The newspaper of the acquired publishing company was not published after the acquisition. The court held that depreciation deductions are allowed with respect to an intangible asset if the taxpayer establishes that (1) the intangible asset has an ascertainable value that is separate and distinct from goodwill and (2) the intangible asset has a limited useful life, the duration of which can be ascertained with reasonable accuracy. A jury verdict finding that the taxpayer had satisfied these requirements was thus permitted to stand.

Following the decision in *Houston Chronicle*, the IRS issued Rev. Rul. 74-456.[11] The ruling stated that, in general, customer lists and certain similar items represent the customer structure of a business and are in the nature of goodwill. However, the ruling also stated that, if, in an unusual case, an intangible asset or a portion thereof does not possess the characteristics of goodwill, is susceptible of valuation, and is of use to the taxpayer in its trade or business for only a limited period of time, a depreciation deduction is allowable. The ruling cited the *Houston Chronicle* case and other cases.

Notwithstanding the abandonment of an absolute mass-asset theory by the IRS as evidenced by the issuance of Rev. Rul. 74-456, litigation concerning the treatment of customer-based intangibles has continued as a matter of facts and circumstances, with some courts holding for taxpayers by allowing depreciation or amortization deductions with respect to certain types of customer-based intangibles and other courts holding for the IRS by denying depreciation or amortization deductions with respect to the same types of customer-based intangibles.

For example, in *Donrey, Inc. v. United States*,[12] the Eighth Circuit Court of Appeals held that a subscription list that was acquired in connection with the purchase of the assets of a newspaper publishing company was amortizable if the taxpayer established a value for the subscription list that was separate and distinct from goodwill and the taxpayer established a useful life for the subscription list.[13] A jury verdict finding that these facts had been established was allowed to stand.[14]

However, in *Newark Morning Ledger Co. v. United States*,[15] the Third Circuit Court of Appeals, reversing a district court decision, held that subscription lists acquired in connection with the acquisition of the assets of a newspaper publishing company were not depreciable. The circuit court concluded that the district court had applied an improper definition of goodwill and that the decision of the district court in concluding that the taxpayer had proven a

[11] 1974-2 C.B. 65.
[12] 809 F.2d 534 (8th Cir. 1987).
[13] See, also, *Panichi v. United States*, 834 F.2d 300 (2nd Cir. 1987) (depreciation deductions allowed with respect to list of trash collection customers).
[14] It is interesting to note that, unlike the *Houston Chronicle* case, the newspaper of the acquired publishing company continued to be published by the acquirer.
[15] 945 F.2d 555 (3rd Cir. 1991) *cert. granted*, April 6, 1992.

value separate and apart from goodwill was clearly erroneous.[16] The circuit court stated that "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." [17] It further stated that "customer lists are generally not depreciable when acquired in conjunction with the sale of the underlying business as a going concern." [18]

As another example of conflicting court decisions involving apparently similar assets, several courts have considered the Federal income tax treatment of the costs of acquiring insurance expirations, which are the records maintained by insurance agents with respect to insurance customers and which generally include such information as the type of insurance, the amount of insurance, and the expiration date of the insurance.[19] In *Richard S. Miller & Sons, Inc. v. United States*,[20] the taxpayer was allowed depreciation deductions with respect to the portion of the purchase price of an insurance agency that was allocable to insurance expirations.[21] On the other hand, in *Decker v. Commissioner*,[22] the Seventh Circuit Court of Appeals affirmed a Tax Court decision that denied depreciation deductions with respect to insurance expirations that were acquired in connection with the purchase of an insurance agency. The Tax Court held that the insurance expirations were inextricably linked to goodwill principally due to the fact that the purchaser continued the operation of the acquired insurance agency with little change.[23]

Similar inconsistent results have occurred with respect to the treatment of "core deposits," which generally include the checking account, savings account and other similar deposits of a bank that may be withdrawn at will by depositors. In *AmSouth Bancorporation v. United States*,[24] a district court held that although the deposits themselves were identifiable, any value created by the expectation that they would continue was not a value separate and distinct from goodwill and, consequently, no depreciation or amortization deductions were allowed. On the other hand, in *Citizens & Southern Corp. v. Commissioner*,[25] *Colorado National Bankshares,*

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[16] The circuit court observed that the taxpayer's value was determined by reference to the expected income from future patronage of the customers on the list, rather than by reference to the estimated cost of replacing the customer list. Although the court did not hold that the latter valuation method would necessarily have been sustained, it observed that the method used created a value not distinguishable from goodwill.

[17] 945 F.2d 555, 567 (3rd Cir. 1991).

[18] *Id.*

[19] Insurance expirations are valuable to an insurance agency because they enable the agency to contact each policyholder at or near the expiration of the insurance coverage with full knowledge of the type, terms, and history of the existing coverage.

[20] 537 F.2d 446 (Ct. Cl. 1976).

[21] See, also, *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223 (1975) (acq.) (depreciation deductions allowed with respect to credit information files); and *Los Angeles Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269 (1977) (depreciation deductions allowed with respect to medical records of a veterinary hospital).

[22] 864 F.2d 51 (7th Cir. 1988), *aff'g* 54 T.C.M. 338 (1987).

[23] 54 T.C.M. 338 (1987) *aff'd* 864 F.2d 51 (7th Cir. 1988).

[24] 681 F. Supp. 698 (N.D. Ala. 1988).

[25] 91 T.C. 463 (1988), *aff'd* 900 F.2d 266 (11th Cir. 1990).

Inc. v. Commissioner,[26] and *IT&S of Iowa v. Commissioner,*[26a] the Tax Court allowed depreciation deductions with respect to core deposits because the taxpayer established that the core deposits had an ascertainable value that was separate and distinct from goodwill and the core deposits had a limited useful life that could be determined with reasonable accuracy.

On January 30, 1990, the IRS issued an Industry Specialization Program coordinated issue paper that discusses the depreciation of customer-based intangibles. The paper concludes that if an ongoing business is acquired with the expectation of continued patronage of the seller's customers such that the purchaser merely steps into the shoes of the seller and the business possesses characteristics of goodwill, then any customer-based intangible acquired in connection with such purchase is inseparable from goodwill and, thus, is not amortizable as a matter of law.

Treatment of certain workforce-based intangibles

Taxpayers that have acquired an ongoing trade or business have also allocated a portion of the purchase price to assets such as agency force, assembled workforce, or other similar workforce-based intangibles. These intangible assets are generally said to represent the value of having a trained, experienced workforce in place as of the date of acquisition (as opposed to having to hire and train a workforce). Unlike customer-based intangibles, the Federal income tax treatment of workforce-based intangibles has not yet resulted in many court decisions.[27] According to a recent report issued by the General Accounting Office (GAO),[28] however, for the 1979 through 1987 taxable years, the IRS proposed income tax adjustments of $866 million with respect to workforce-based intangibles.

On January 30, 1990, the IRS issued an Industry Specialization Program coordinated issue paper which stated that "any value associated with having a trained staff of employees in place represents the going concern value of an acquired business" and, consequently, the portion of the purchase price of an acquired trade or business that is allocable to the trained workforce is not amortizable. This position of the IRS was recently upheld by the Tax Court in *Ithaca Industries, Inc. v. Commissioner.*[29] In *Ithaca Industries,* the taxpayer allocated $7.7 million of a total purchase price of $160 million to the assembled workforce of an underwear manufacturer. The Tax Court held that the assembled workforce of the taxpayer's

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[26] 60 T.C.M. 771 (1990).

[26a] 97 T.C. 496 (1991).

[27] Taxpayers generally have been allowed depreciation deductions with respect to employment contracts. See, e.g., Rev. Rul. 67-379, 1967-2 C.B. 127 (professional baseball player contracts depreciable); Rev. Rul. 71-137, 1971-1 C.B. 104 (professional football player contracts depreciable); and *KFOX, Inc. v. United States,* 510 F.2d 1365 (Ct. Cl. 1975) (radio disc jockey contracts depreciable). But, see, *National Service Industries, Inc. v. United States* 379 F. Supp. 831 (N.D. Ga. 1973) (employee contracts not depreciable in absence of proof of value or useful lives); *Forman, Inc. v. United States,* 89-1 U.S.T.C. Par. 9165 (D.Md. 1989) ("advantageous" union contract not depreciable); and *The Barnes Group, Inc. v. United States,* 872 F.2d 528 (2nd Cir. 1989) (no allocation of purchase price allowed to employment contracts entered into in contemplation of, and dependent upon, acquisition).

[28] *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets,* Report to the Joint Committee on Taxation by the General Government Division of the General Accounting Office (GAO/GGD-91-88), August 19, 1991 (hereinafter referred to as the GAO Report), p. 4.

[29] 97 T.C. 253 (1991).

trade or business was not a wasting asset separate and distinct from going concern value and, consequently, the portion of the purchase price allocable to the assembled workforce was not amortizable for Federal income tax purposes.

Treatment of government rights of an indefinite duration

Taxpayers generally have not been allowed depreciation or amortization deductions with respect to renewable rights that are granted by a governmental entity because a useful life for the rights generally is not determinable with reasonable accuracy. For example, in *KWTX Broadcasting Co. v. Commissioner*,[30] the Tax Court denied depreciation deductions with respect to a 3-year license issued by the Federal Communications Commission (FCC) to operate a television broadcasting station. The court's holding was based on the fact that the FCC had never refused to renew a license, and, consequently, the license was considered to be of an indefinite duration.[31]

In addition, in *Nachman v. Commissioner*,[32] the Fifth Circuit Court of Appeals denied depreciation deductions with respect to the premium paid for a retail liquor license that was valid for only 5 months after the date of acquisition. The court held that the useful life of the liquor license was likely to continue indefinitely because it was the established practice in issuing renewal licenses to favor the holders of existing licenses over other applicants.[33] Similarly, in *Toledo TV Cable Co. v. Commissioner*,[34] the taxpayer was not allowed depreciation deductions with respect to cable television franchises granted by a governmental entity because the taxpayer failed to establish that the franchises had a determinable useful life.

On the other hand, in *Chronicle Publishing Co. v. Commissioner*,[35] the taxpayer was allowed depreciation deductions with respect to cable television franchises because the taxpayer was able to establish useful lives for the franchises that were determinable with reasonable accuracy. In *Chronicle Publishing Co.*, the franchises did not contain renewal options or other renewal provisions and no practice or custom of granting renewals had been established.

In contrast to cases where the amortization of government contract rights has been disallowed under section 167 of the Code, the Tax Court has recently allowed amortization of these rights under

[30] 31 T.C. 952 (1959), *aff'd per curiam*, 272 F.2d 406 (5th Cir. 1959).

[31] See, also, *Richmond Television Corp. v. United States*, 354 F.2d 410 (4th Cir. 1965), *vacated and remanded on other grounds*, 382 U.S. 68 (1965) (depreciation deductions not allowed with respect to cost of training personnel for a new television station because FCC license had an indefinite useful life); Rev. Rul. 56-520, 1956-2 C.B. 170 (depreciation deductions not allowed with respect to cost of FCC license to operate a television broadcasting station); and Rev. Rul. 64-124, 1964-1 (Part 1) C.B. 105 (same). But, see, *Jefferson-Pilot Corp. v. Commissioner*, 98 T.C. No. 32 (April 13, 1992) (FCC radio broadcast license constitutes a franchise and, consequently, the portion of the purchase price of an acquired radio station that is attributable to the FCC license is amortizable under section 1253 of the Code).

[32] 191 F.2d 934 (5th Cir. 1951).

[33] See, also, *Shufflebarger v. Commissioner*, 24 T.C. 980 (1955) (depreciation deductions not allowed with respect to grazing privileges because the taxpayer was unable to establish a useful life due to a preferential right to renew such privileges); and *Uecker v. Commissioner*, 81 T.C. 983 (1983), *aff'd per curiam*, 766 F.2d 909 (5th Cir. 1985) (same).

[34] 55 T.C. 1107 (1971), *aff'd per curiam*, 483 F.2d 1398 (9th Cir. 1973).

[35] 67 T.C. 964 (1977), *nonacq.* 1980-1 C.B. 2.

section 1253 of the Code. In *Tele-Communications, Inc. v. Commissioner*,[36] the taxpayer asserted in the course of the examination of the taxpayer's income tax return that the rights to operate a cable television system that were granted by a local governmental unit should constitute a franchise for purposes of section 1253 and, thus, should be eligible for the special cost recovery rules under section 1253. The Tax Court concluded that section 1253 applied to the cable television rights, and, consequently, the taxpayer was allowed amortization deductions with respect to the cost of acquiring the cable television rights from the prior operator of the cable television system, even though the rights may extend for an indefinite period. Similarly, the Tax Court in *Jefferson-Pilot Corp. v. Commissioner*[36a] held that an FCC radio broadcasting license was amortizable under section 1253.

Treatment of franchises, trademarks, and trade names

Apart from the application of section 1253, various cases have held that the cost of acquiring a franchise, trademark, or trade name was not depreciable or amortizable because the taxpayer was unable to establish that (1) the franchise, trademark, or trade name was distinguishable from goodwill or (2) the franchise, trademark, or trade name had a limited useful life that was determinable with reasonable accuracy.

For example, in *Clark Thread Co. v. Commissioner*,[37] the court denied a deduction for the cost of securing a competitor's agreement to discontinue the use of a trade name based on the court's conclusion that trade names are like goodwill in their economic characteristics and effect. The court stated that goodwill and trade names may vary in value through the years but will be of ongoing usefulness indefinitely. As a further example, in *Dunn v. United States*,[38] the Tenth Circuit Court of Appeals held that various payments made in connection with a "Dairy Queen" franchise were not amortizable because the taxpayer failed to establish a useful life for the franchise agreement.

In cases where a useful life has been established with reasonable accuracy, depreciation deductions have been allowed with respect to a franchise. For example, in *Chronicle Publishing Co. v. Commissioner*,[39] depreciation deductions were allowed with respect to cable television franchises because the taxpayer established useful lives for the franchises.[40]

Section 1253 provides special rules with respect to payments made on account of certain transfers of a franchise, trademark, or trade name. Under section 167, the acquirer of a franchise, trademark or trade name generally may amortize the cost of acquiring such an asset over the useful life of the asset if a useful life may be established with reasonable accuracy. However, under section 1253,

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[36] 95 T.C. 495 (1990), appeal filed with the Tenth Circuit Court of Appeals.

[36a] 98 T.C. No. 32 (April 13, 1992).

[37] 100 F.2d 257 (3rd Cir. 1939).

[38] 400 F.2d 679 (10th Cir. 1969).

[39] 67 T.C. 964 (1977), *nonacq.* 1980-1 C.B. 2.

[40] Compare, *Toledo TV Cable Co. v. Commissioner*, 55 T.C. 1107 (1971), *aff'd per curiam*, 483 F.2d 1398 (9th Cir. 1973) (depreciation deductions not allowed with respect to cable television franchises because the taxpayer was unable to establish that franchises had determinable useful lives.)

taxpayers may elect under certain circumstances to amortize the cost of acquiring a franchise, trademark, or trade name over 25 years (even if a useful life cannot be established). In addition, an amortization period equal to the shorter of 10 years (rather than 25 years) or the term of the transfer agreement is provided for certain small transactions (i.e., those transactions involving fixed-sum amounts that do not exceed $100,000).[41]

Although the 25-year and 10-year periods of section 1253 do not explicitly apply to a franchise that is sold by one franchisee to another in a transaction that would be eligible for capital gains treatment,[42] the IRS ruled in Rev. Rul. 88-24[43] that section 1253 applies in such a case if the franchisor retains a significant power, right, or continuing interest with respect to the subject matter of the franchise. Accordingly, if a franchise under which the franchisor retains such rights is sold by one franchisee to another, the portion of the purchase price that is attributable to the franchise is generally amortizable over the lesser of 25 years or the useful life, if a shorter life can be established with reasonable accuracy.

In addition, under section 1253, an ordinary and necessary business expense deduction is allowed for any amount that is contingent on the productivity, use, or disposition of a franchise, trademark, or trade name if the amount is paid as part of a series of payments that (1) are payable at least annually throughout the term of the transfer agreement, and (2) are substantially equal in amount or are payable under a fixed formula.

Disputes have arisen regarding what assets may properly be considered "franchises" within the meaning of section 1253 and, thus, be entitled to the favorable 25-year (or 10-year) amortization election that applies in the absence of an ascertainable useful life. The IRS has contended, for example, that governmental rights cannot qualify as franchises for this purpose. The Tax Court has rejected this argument in *Tele-Communications, Inc. v. Commissioner*[44] and *Jefferson-Pilot Corp. v. Commissioner*.[45] Disputes also have arisen as to whether particular arrangements between private parties constitute a franchise for purposes of section 1253. For example, the issue whether certain television network affiliation contracts qualify for the cost recovery provisions of section 1253 has been raised in several pending cases.

Finally, disputes have arisen regarding what portion, if any, of the purchase price of an acquired trade or business is properly at-

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[41] Prior to the enactment of the Omnibus Budget Reconciliation Act of 1989, a 10-year amortization period, rather than a 25-year period, generally applied to all transactions including those with fixed-sum amounts in excess of $100,000.

[42] The election of a 25-year amortization period applies where the transfer of a franchise, trademark, or trade name is "not ... treated as a sale or exchange of a capital asset" by reason of section 1253(a), which denies such treatment to a transferor "if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name." (Secs. 1253(d)(2) and (3), 1253(a).)

[43] 1988-1 C.B. 306.

[44] 95 T.C. 495 (1990) (rights to operate a cable television system constitute a franchise for purposes of section 1253), appeal filed with the Tenth Circuit Court of Appeals.

[45] 98 T.C. No. 32 (April 13, 1992) (FCC radio broadcast license constitutes a franchise for purposes of section 1253).

tributable to the "franchise" as distinct from some other going concern element of a franchised business.[46]

Treatment of covenants not to compete

As part of the sale of a trade or business, the purchaser and seller often enter into an agreement frequently stated to be for some fixed time period pursuant to which the seller agrees not to compete with the trade or business acquired by the purchaser. As in the case of other intangible assets, depreciation deductions are allowed with respect to a covenant not to compete only if the covenant is distinguishable from goodwill and the covenant has a useful life that is determinable with reasonable accuracy.

The issues of (1) whether a covenant not to compete is depreciable for Federal income tax purposes and (2) what portion of the purchase price of an acquired trade or business is allocable to a covenant not to compete have been the subject of numerous disputes between taxpayers and the IRS. In many cases, the purchaser and the seller have not assigned any purchase price to the covenant not to compete. The courts generally have not allowed depreciation deductions with respect to a covenant not to compete if no portion of the purchase price has been specifically assigned to the covenant.[47] If, on the other hand, the amount paid for a covenant not to compete has been separately bargained for and has a basis in economic reality, the courts have generally respected the purchase price allocation, particularly where the parties have had adverse tax interests with respect to the allocation.[48]

Prior to the enactment of the Tax Reform Act of 1986, the seller and the purchaser of a trade or business generally had significant adverse interests with respect to the allocation of purchase price to a covenant not to compete. First, the tax rate that applied to long-term capital gains was significantly lower than the rate that applied to ordinary income. In addition, corporate-level capital gain was generally tax-free under the rules relating to corporate liquidations. The adversity arose under prior law because the amount received by a seller under a covenant not to compete generally was treated as ordinary income, while the remaining amount of the purchase price was generally treated as capital gain. For the purchaser, the amount paid for the covenant not to compete generally was amortizable over the relatively short term of the covenant,

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[46] See, e.g., *Tele-Communications, Inc. v. Commissioner*, 95 T.C. 495 (1990) (Tax Court agreed with one of taxpayer's two experts regarding the amount properly allocable to going concern value or some other nonamortizable asset distinct from a franchise); and *Nachman v. Commissioner*, 191 F.2d 934 (5th Cir. 1951).

[47] See, e.g., *Delsea Drive-In Theatres, Inc. v. Commissioner*, 379 F.2d 316 (3rd Cir. 1967); and *General Insurance Agency, Inc. v. Commissioner*, 401 F.2d 324 (4th Cir. 1968). See, also, *Forward Communications Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979), in which it was stated as a fact that a 5-year period for a covenant was chosen because the taxpayer felt that after that period the seller would lose its effectiveness in the relevant market. The court concluded that the covenant was not a separable wasting asset, but merely protective of the goodwill that the taxpayer acquired in the purchase.

[48] See, e.g., *Christensen Machine Co. v. Commissioner*, 18 B.T.A. 256 (1929); *Commissioner v. Gazette Telegraph Co.*, 209 F.2d 926 (10th Cir. 1954); and *United Elchem Industries, Inc. v. Commissioner*, 42 T.C.M. 460 (1981). See, also, *Ullman v. Commissioner*, 264 F.2d 305 (2nd Cir. 1959); and *Commissioner v. Danielson*, 378 F.2d 771 (3rd Cir. 1967), *cert. denied*, 389 U.S. 858. Section 1060(a) of the Code, as amended by the Omnibus Budget Reconciliation Act of 1990, forbids parties who agree in writing as to the allocation of purchase price to challenge the allocation unless certain standards of the *Danielson* case are satisfied. The IRS, however, may challenge the allocation.

while the remaining amount of the purchase price was allocated to longer-lived depreciable assets or to nondepreciable assets.

Under present law, the purchaser of a trade or business continues to have an incentive to allocate purchase price to a covenant not to compete. With the elimination of the preference for long-term capital gains and the repeal of the tax-free treatment of corporate-level capital gain, however, the seller of a trade or business no longer has a significant adverse interest. Anecdotal evidence from some taxpayers and practitioners suggests that the amount of the purchase price of an acquired trade or business that is allocated to a covenant not to compete may have increased in some situations since the enactment of the Tax Reform Act of 1986.

Treatment of patents and copyrights

The Treasury Department regulations relating to the depreciation of intangible property provide that patents and copyrights are types of intangible property with respect to which depreciation deductions are allowed for Federal income tax purposes.[49] The legal life of a patent issued by the United States Patent Office is 17 years, while the legal life of a copyright generally extends for the life of the author plus 50 years. The cost of acquiring a patent or copyright, however, need not be amortized over the remaining legal life of the patent or copyright as of the date of acquisition. Instead, a taxpayer may establish that the useful life of the patent or copyright is shorter than the legal life, in which case the cost of the patent or copyright would be recovered over such shorter period. If the purchase price of a patent is payable on an annual basis as a fixed percentage of the revenue derived from the use of the patent, the amount of depreciation allowed for any taxable year with respect to the patent generally equals the amount of the royalty paid or incurred during such year.[50]

Treatment of contracts with a stated life

A taxpayer that acquires the assets of a trade or business will often acquire rights under contracts that were entered into by the seller of the trade or business with third parties.[51] For example, the buyer may step into the shoes of the seller with respect to a supply contract that grants the buyer more favorable terms than the buyer could obtain on its own with respect to the subject matter of the contract.[52] The portion of the purchase price of an

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[49] Treas. Reg. sec. 1.167(a)-3.

[50] See, e.g., *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945) (acq.); *Newton Insert Co. v. Commissioner*, 61 T.C. 570 (1974), *aff'd per curiam*, 545 F.2d 1259 (9th Cir. 1976); and Rev. Rul. 67-136, 1967-1 C.B. 58.

[51] In addition, a taxpayer may incur costs in connection with entering into a contract. These costs generally must be capitalized and amortized over the life of the contract. For example, Treasury regulation section 1.162-11 and section 178 of the Code generally provide that costs incurred to acquire a leasehold interest must be capitalized and amortized over the term of the lease, in certain cases taking into account renewal options.

[52] Taxpayers also have assigned valued to, and claimed amortization deductions with respect to, contracts for which the taxpayer provides goods or services to third parties. Some courts have allowed amortization deductions with respect to these customer-based contracts, while others have held such contracts to be analogous to goodwill. Compare *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966) (amortization deductions allowed with respect to consumer term loans) with *U.S. Industrial Alcohol Co. v. Commissioner*, 137 F.2d 511 (2nd Cir. 1943) (amortization deductions not allowed with respect to contracts to supply products to customers because such contracts were akin to goodwill). For a discussion of customer-based intangibles, see above.

acquired trade or business that is assigned to a favorable contract may be amortized for Federal income tax purposes if the buyer establishes that (1) the contract has a limited useful life, the duration of which can be established with reasonable accuracy, and (2) the contract has an ascertainable value that is separate and distinct from goodwill.[53]

Taxpayers have successfully demonstrated that contracts to acquire supplies at a specific price are separate and distinct from goodwill or going concern value even though the supplies that are the subject of the contract were essential to the operation of the taxpayers' trade or business.[54] However, taxpayers have had mixed results in demonstrating that acquired contracts had limited useful lives, particularly where the contracts are renewable. The probability of future renewals generally is a question of fact.[55]

For example, in *Westinghouse Broadcasting Corp. v. Commissioner*,[56] the Third Circuit Court of Appeals held that a television network affiliation contract that had a term of two years, but was automatically renewable an indefinite number of times, had an indefinite life and was not subject to amortization. As a further example, in *Forward Communications Corp. v. United States*,[57] the Court of Claims held that amounts allocated to advertising contracts acquired in the purchase of a television station could not be deducted over the stated period of the contracts because of difficulties of identifying values and because of the likelihood that the contracts might be renewed. Similarly, in *ThriftiCheck Service Corporation v. Commissioner*, the Second Circuit Court of Appeals held that amounts allocated to 200 customer contracts of an acquired business were not amortizable. A reasonable determination of the life of any benefits provided by the contracts could not be made, given the combination of provisions for cancellation and automatic renewal in the contracts and the history and prospect of continuing relations with the customers beyond the initial term and first renewal period in the contracts.[58]

On the other hand, in *Ithaca Industries, Inc. v. Commissioner*,[59] the Tax Court recently decided that the cost of acquiring contracts that allowed the taxpayer to purchase raw materials at a price below the current market price may be amortized for Federal income tax purposes. The court found that the contracts were not automatically renewable, and any contract renewal would likely be distinguishable from the original existing contract. In addition, the fact that the parties could modify certain terms of the contracts during the period covered by the contracts did not cause the contracts to be indefinite in length.

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[53] *Southern Bancorporation, Inc. v. Commissioner*, 847 F.2d 131, 136-137 (4th Cir. 1988).

[54] See, e.g., *Triangle Publications, Inc. v. Commissioner*, 54 T.C. 138 (1970); and *Ithaca Industries, Inc. v. Commissioner*, 97 T.C. 253 (1991).

[55] *Toledo TV Cable Co. v. Commissioner*, 55 T.C. 1107, 1117 (1971), *aff'd. per curiam*, 483 F.2d 1398 (9th Cir. 1973).

[56] 309 F.2d 279 (3rd Cir. 1962), *cert. denied*, 372 U.S. 935.

[57] 608 F.2d 485 (Ct. Cl. 1979).

[58] 278 F.2d 1, (2nd Cir. 1961), *aff'g* 33 T.C. 1038 (1960). Compare, *Seaboard Finance Co. v. Commissioner*, 367 F.2d 646 (9th Cir. 1966).

[59] 97 T.C. 253 (1991).

General issues regarding valuation of intangible assets

In addition to issues regarding the identification of separate intangible assets, issues frequently arise regarding the valuation of intangible assets. These issues may be closely related to, or even determinative of, whether an asset has been identified that is separate and distinct from goodwill. Alternatively, these issues may arise in situations where the existence of a separate asset has been acknowledged.

Present law contains very broad rules regarding the allocation of purchase price among the assets of an acquired trade or business. These rules do not provide a method other than a facts and circumstances test for allocating purchase price among different assets, including the allocation of purchase price among different amortizable or depreciable assets.

In general, under the present-law allocation rules, if a business is acquired, purchase price must be allocated first to cash and certain cash equivalents, second to marketable securities and certain other similar items, third to all assets (tangible or intangible) not in another category, and, fourth to nondepreciable goodwill or going concern value.[60]

Prior to the adoption of the present-law rules, goodwill and going concern value were not explicitly required to be considered a "residual" category. Rather, some taxpayers would separately identify an initial value for such assets along with values for all other assets. In cases where taxpayers contended that they had paid a "premium" price, (i.e., an amount greater than the value of all the assets), some taxpayers interpreted the law to permit allocating this residual amount proportionately among all assets, with the result that the depreciable value of some assets would exceed their identified fair market value.

Present law expressly requires any excess purchase price over the identified fair market value of cash equivalents, marketable securities, and depreciable assets to be allocated entirely to nondepreciable goodwill or going concern value. However, present law does not generally provide any statutory limits on the extent to which purchase price may be allocated to amortizable assets rather than to nonamortizable goodwill or going concern value.[61] Present law also does not provide a method for allocating purchase price among amortizable assets. Thus, disputes often arise under present law over whether the value of particular amortizable assets are "overstated" or "understated." Present law also does not provide rules other than facts and circumstances for determining whether the taxpayer has made a "premium" purchase (with resulting nonamortizable goodwill or going concern value) or a "bargain" purchase (in which case some taxpayers may argue that they obtained amortizable assets for less than fair market value and, under the

[60] Section 1060 of the Code for asset acquisitions; and Temp. and Prop. Reg. sec. 1.338(b)-2T under section 338(b)(5) for stock acquisitions treated as asset acquisitions under a taxpayer election. The allocation rules differ in some respects depending upon whether the section 1060 or section 338 rules apply.

[61] Section 1056 of the Code creates a presumption that no more than 50 percent of the purchase price of acquiring a professional sports franchise is allocable to amortizable player contracts.

priority allocation rules, are thus entitled to allocate virtually nothing to goodwill or going concern value).

Present law contains reporting rules that require the buyer and seller of certain assets to report the values allocated to various assets or categories of assets (sec. 1060(b) and regulations). Present law does not contain an explicit penalty that applies if the buyer and seller do not allocate the same amounts to the same assets. However, if, in connection with an acquisition, the transferor and transferee agree in writing as to the allocation of any consideration or the fair market value of any assets, neither of the parties may thereafter challenge the allocation unless the Secretary of the Treasury determines the allocation is not appropriate (sec. 1060(a)). Reporting is also required, as prescribed by Treasury Department regulations, if, in connection with the transfer of certain interests in an entity, there is also a covenant not to compete or other agreement with the transferee (sec. 1060(e)).

Taxpayers have used different methods to value intangible assets. Such methods include a replacement cost approach ("cost"), a comparable transactions (or "market") approach (if there is a comparable intangible that is sold between unrelated parties), and an approach based on the allocation of a portion of estimated future earnings to a particular intangible and discounting such earnings to their present value ("future earnings"). With respect to a single business acquisition, some intangibles may be valued by one method and others by another. In addition, different acquirers may use different methods to value similar types of intangibles.

Disputes may arise over any aspect of the allocation, including whether a particular asset should properly be valued based on cost, on market, or on future earnings. If a cost method is used, there may be disputes regarding how that cost is determined and what expenses should be taken into account in determining the cost. If a market approach is used, there may be disputes regarding whether there are in fact comparable arm's length transactions. If an earnings method is used, there may be disputes regarding what portion of future earnings should be allocated to one intangible rather than to another, the time period over which the earnings should be estimated, and what discount rate should be used to determine present value.

In litigation, taxpayers and the IRS typically produce expert testimony regarding the valuation of particular assets. Frequently, the experts disagree about particular valuations. Moreover, the several experts for one party may not be in complete agreement regarding valuations.

Comparison of present-law treatment of tangible property

The rules governing the depreciation or amortization of intangible property differ from the rules governing the depreciation of tangible property, which have evolved over many years. Under the present-law rules applicable to tangible property, specific lives are assigned to specific types of depreciable property. The experience of a particular business enterprise or a particular taxpayer with respect to an asset generally is not relevant.

Originally, the tangible property depreciation rules were similar to the present-law rules governing intangibles. Tangible property

depreciation was determined based on the facts and circumstances of each case. The rules later evolved to permit the use of guideline lives without precluding taxpayers from showing a shorter life. In the past decade, the use of specified lives became mandatory for tangible assets.[62] Issues may still arise regarding the allocation of purchase price among tangible assets (for example, between a building, which is depreciable, and land, which is not). However, the adoption of specified lives and methods generally has eliminated disputes concerning the depreciation of tangible property, regardless of whether such lives and methods corresponds to any taxpayer's actual experience.

Treatment of self-created assets

Taxpayers are allowed a deduction for all the ordinary and necessary expenses that are paid or incurred during a taxable year in carrying on any trade or business (sec. 162(a)). However, taxpayers generally may not deduct currently the costs of acquiring, permanently improving, or increasing the value of any property (sec. 263(a)). These costs generally must be capitalized.[63] In addition, the direct and indirect costs of a taxpayer that are allocable to property that is acquired by the taxpayer for resale or that are allocable to certain real or tangible personal property produced by the taxpayer must be included in inventory or capitalized (sec. 263A).[64]

Costs that are paid or incurred to acquire an intangible asset generally must be capitalized. However, some costs that are paid or incurred to create, maintain, or enhance the value of certain intangible assets may be deducted as ordinary and necessary business expenses for the year that the costs are paid or incurred.[65] For example, advertising expenses generally may be deducted for the year that the expenses are paid or incurred even though the advertising often results in income in future taxable years.[66] Likewise, costs incurred to train employees generally may be deducted for the year that the costs are paid or incurred even though the training results in a more knowledgeable or valuable workforce.[67] Thus, although taxpayers generally must capitalize the costs of acquiring intangible assets from another person (such as the costs of acquiring a customer list or goodwill), taxpayers generally may currently deduct the costs incurred to develop or maintain such intangible assets.

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[62] For a more extensive discussion of the history of tangible asset depreciation, see the GAO Report, n. 26, pp. 16-18. In the case of tangible property, the specified lives often were designed to contain an incentive accelerated depreciation element.

[63] See, e.g., *American Seating Co. v. Commissioner*, 4 B.T.A. 1588 (1926) (amounts paid for exclusive licenses for use of designs and inventions must be capitalized); *KWTX Broadcasting Company, Inc. v. Commissioner*, 31 T.C. 952 (1959), *aff'd per curiam*, 272 F.2d 406 (5th Cir. 1959) (costs incurred to obtain a television construction permit and broadcasting licenses were capital expenditures); and *Manhattan Co. of Virginia, Inc. v. Commissioner*, 50 T.C. 78 (1968) (a customer list purchased by a laundry was an intangible asset, the cost of which must be capitalized).

[64] For this purpose, the term "tangible personal property" includes a film, sound recording, video tape, book or similar property.

[65] Section 174 of the Code also permits the immediate deduction of research and experimental costs that contribute to the creation of intangibles such as technology and similar items. However, a taxpayer who purchases such intangibles from another taxpayer must capitalize the price paid and amortize it over the useful life of the asset if one can be established.

[66] See, e.g., Treas. Reg. sec. 1.162-20(a)(2).

[67] See, e.g., *Knoxville Iron Co. v. Commissioner*, 18 T.C.M. 251 (1959) (training costs held to be deductible when incurred); and *Cleveland Electric Illuminating Co. v. Commissioner*, 7 Cl. Ct. 220 (1985) (certain training costs were deductible when incurred; other training costs required to be capitalized because the costs related to the start-up of a new business).

III. DESCRIPTION OF PROPOSALS

A. Section 4501 of H.R. 4210 [68]

Overview

Section 4501 of H.R. 4210 would allow an amortization deduction with respect to the capitalized costs of certain intangible property (defined as a "section 197 intangible") that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction would be determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible ratably over a 14-year period that begins with the month that the intangible is acquired.[69] No other depreciation or amortization deduction would be allowed with respect to a section 197 intangible that is acquired by a taxpayer.

In general, the bill would apply to a section 197 intangible acquired by a taxpayer regardless of whether it is acquired as part of a trade or business. In addition, the bill generally would apply to a section 197 intangible that is treated as acquired under section 338 of the Code. The bill generally would not apply to a section 197 intangible that is created by the taxpayer if the intangible is not created in connection with a transaction (or series of related transactions) that involves the acquisition of a trade or business or a substantial portion thereof.

Except in the case of amounts paid or incurred under certain covenants not to compete (or under certain other arrangements that have substantially the same effect as covenants not to compete) and certain amounts paid or incurred on account of the transfer of a franchise, trademark, or trade name, the bill generally would not apply to any amount that is otherwise currently deductible (*i.e.*, not capitalized) under present law.

Definition of section 197 intangible

In general

The term "section 197 intangible" would be defined as any property that is included in any one or more of the following categories: (1) goodwill and going concern value; (2) certain specified types of intangible property that generally relate to workforce, information base, know-how, customers, suppliers, or other similar items; (3) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof; (4) any covenant not to

[68] H.R. 4210, the "Tax Fairness and Economic Growth Act of 1992," was passed by Congress on March 20, 1992, and was vetoed by the President.

[69] In the case of a short taxable year, the amortization deduction would be based on the number of months in such taxable year.

compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (5) any franchise, trademark, or trade name.

Certain types of property, however, would be specifically excluded from the definition of the term "section 197 intangible." The term "section 197 intangible" would not include: (1) any interest in a corporation, partnership, trust, or estate; (2) any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract; (3) any interest in land; (4) certain computer software; (5) certain interests in films, sound recordings, video tapes, books, or other similar property; (6) certain rights to receive tangible property or services; (7) certain interests in patents or copyrights; (8) any interest under an existing lease of tangible property; (9) any interest under an existing indebtedness (except for the deposit base and similar items of a financial institution); and (10) a franchise to engage in any professional sport, and any item acquired in connection with such a franchise.

Goodwill and going concern value

For purposes of the bill, goodwill would be defined as the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor.

In addition, for purposes of the bill, going concern value would be defined as the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern. Going concern value would include the value that is attributable to the ability of a trade or business to continue to function and generate income without interruption notwithstanding a change in ownership. Going concern value also would include the value that is attributable to the use or availability of an acquired trade or business (for example, the net earnings that otherwise would not be received during any period were the acquired trade or business not available or operational).

Workforce, information base, know-how, customer-based intangibles, supplier-based intangibles and other similar items

Workforce.—The term "section 197 intangible" would include workforce in place (which is sometimes referred to as agency force or assembled workforce), the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a highly-skilled workforce would be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring an existing employment contract (or contracts) or a relationship with employees or consultants (including but not limited to any "key employee" contract or relationship) as part of the ac-

quisition of a trade or business would be amortized over the 14-year period specified in the bill.

Information base.—The term "section 197 intangible" would include business books and records, operating systems, and any other information base including lists or other information with respect to current or prospective customers (regardless of the method of recording such information). Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems would be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring customer lists, subscription lists, insurance expirations,[70] patient or client files, or lists of newspaper, magazine, radio or television advertisers would be amortized over the 14-year period specified in the bill.

Know-how.—The term "section 197 intangible" would include any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. For this purpose, the term "section 197 intangible" would include package designs, computer software, and any interest in a film, sound recording, video tape, book, or other similar property, except as specifically provided otherwise in the bill.[71]

Customer-based intangibles.—The term "section 197 intangible" would include any customer-based intangible, which would be defined as the composition of market, market share, and any other value resulting from the future provision of goods or services pursuant to relationships with customers (contractual or otherwise) in the ordinary course of business. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of customer base, circulation base, undeveloped market or market growth, insurance in force, mortgage servicing contracts, investment management contracts, or other relationships with customers that involve the future provision of goods or services, would be amortized over the 14-year period specified in the bill. On the other hand, the portion (if any) of the purchase price of an acquired trade or business that is attributable to accounts receivable or other similar rights to income for those goods or services that have been provided to customers prior to the acquisition of a trade or business would not to be taken into account under the bill.[72]

In addition, the bill specifically provides that the term "customer-based intangible" would include the deposit base and any similar asset of a financial institution. Thus, for example, the portion (if any) of the purchase price of an acquired financial institution that is attributable to the checking accounts, savings accounts,

[70] Insurance expirations are records that are maintained by insurance agents with respect to insurance customers. These records generally include information relating to the type of insurance, the amount of insurance, and the expiration date of the insurance.

[71] See below for a description of the exceptions for certain patents, certain computer software, and certain interests in films, sound recordings, video tapes, books, or other similar property.

[72] As under present law, the portion of the purchase price of an acquired trade or business that is attributable to accounts receivable would be allocated among such receivables and would be taken into account as payment is received under each receivable or at the time that a receivable becomes worthless.

escrow accounts and other similar items of the financial institution would be amortized over the 14-year period specified in the bill.

Supplier-based intangibles.—The term "section 197 intangible" would include any supplier-based intangible, which would be defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a favorable relationship with persons that provide distribution services (for example, favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts, would be amortized over the 14-year period specified in the bill.[73]

Other similar items.—The term "section 197 intangible" would also include any other intangible property that is similar to workforce, information base, know-how, customer-based intangibles, or supplier-based intangibles.

Licenses, permits, and other rights granted by governmental units

The term "section 197 intangible" would include any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof (even if the right is granted for an indefinite period or the right is reasonably expected to be renewed for an indefinite period).[74] Thus, for example, the capitalized cost of acquiring from any person a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (which is sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license would be amortized over the 14-year period specified in the bill. For purposes of the bill, the issuance or renewal of a license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof would be considered an acquisition of such license, permit, or other right.

Covenants not to compete and other similar arrangements

The term "section 197 intangible" would include any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete; hereafter "other similar arrangement") entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof). For this purpose, an interest in a trade or business would include not only the assets of a trade or business, but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business.

Any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) entered into in connection

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[73] See below, however, for a description of the exception for certain rights to receive tangible property or services from another person.

[74] A right granted by a governmental unit or an agency or instrumentality thereof that constitutes an interest in land or an interest under a lease of tangible property would be excluded from the definition of a section 197 intangible. See below for a description of the exceptions for interests in land and for interests under leases of tangible property.

with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof) would be chargeable to capital account and would be amortized ratably over the 14-year period specified in the bill. In addition, any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) after the taxable year in which the covenant (or other similar arrangement) was entered into would be amortized ratably over the remaining months in the 14-year amortization period that applies to the covenant (or other similar arrangement) as of the beginning of the month that the amount is paid or incurred.

For purposes of this provision, an arrangement that requires the former owner of an interest in a trade or business to continue to perform services (or to provide property or the use of property) that benefit the trade or business would be considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered (or for the property or use of property actually provided) by the former owner. As under present law, to the extent that the amount paid or incurred under a covenant not to compete (or other similar arrangement) represents additional consideration for the acquisition of stock in a corporation, such amount would not be taken into account under this provision but, instead, would be included as part of the acquirer's basis in the stock.

Franchises, trademarks, and trade names

The term "section 197 intangible" would include any franchise, trademark, or trade name. For this purpose, the term "franchise" would be defined as under present law to include any agreement that provides one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area (sec. 1253(b)(1)). In addition, as provided under present law, the renewal of a franchise, trademark, or trade name would be treated as an acquisition of such franchise, trademark, or trade name.[75]

The bill would continue the present-law treatment of certain contingent amounts that are paid or incurred on account of the transfer of a franchise, trademark, or trade name. Under these rules, a deduction would be allowed for amounts that are contingent on the productivity, use, or disposition of a franchise, trademark, or trade name only if (1) the contingent amounts are paid as part of a series of payments that are payable at least annually throughout the term of the transfer agreement, and (2) the payments are substantially equal in amount or payable under a fixed formula (sec. 1253(d)(1)). Any other amount, whether fixed or contingent, that is paid or incurred on account of the transfer of a franchise, trademark, or trade name would be chargeable to capital account and

[75] Only the costs incurred in connection with the renewal, however, would be amortized over the 14-year period that begins with the month that the franchise, trademark, or trade name is renewed. Any costs incurred in connection with the issuance (or an earlier renewal) of a franchise, trademark, or trade name would continue to be taken into account over the remaining portion of the amortization period that began at the time of such issuance (or earlier renewal).

would be amortized ratably over the 14-year period specified in the bill.

Exceptions to the definition of a section 197 intangible

In general.—The bill would provide several exceptions to the definition of the term "section 197 intangible." Several of the exceptions contained in the bill would apply only if the intangible property is not acquired in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business. It is anticipated that the Treasury Department would exercise its regulatory authority to require any intangible property that would otherwise be excluded from the definition of the term "section 197 intangible" to be taken into account under the bill under circumstances where the acquisition of the intangible property is, in and of itself, the acquisition of an asset which constitutes a trade or business or a substantial portion of a trade or business.

The determination of whether acquired assets constitute a substantial portion of a trade or business would be based on all of the facts and circumstances, including the nature and the amount of the assets acquired as well as the nature and the amount of the assets retained by the transferor. It is not intended, however, that the value of the assets acquired relative to the value of the assets retained by the transferor would be determinative of whether the acquired assets constitute a substantial portion of a trade or business.

For purposes of the bill, a group of assets would constitute a trade or business if the use of such assets would constitute a trade or business for purposes of section 1060 of the Code (*i.e.*, if the assets are of such a character that goodwill or going concern value could under any circumstances attach to the assets). In addition, the acquisition of a franchise, trademark or trade name would constitute the acquisition of a trade or business or a substantial portion of a trade or business.

In determining whether a taxpayer has acquired an intangible asset in a transaction (or series of related transactions) that involves the acquisition of assets that constitute a trade or business or a substantial portion of a trade or business, only those assets acquired in a transaction (or a series of related transactions) by a taxpayer (and persons related to the taxpayer) from the same person (and any related person) would be taken into account. In addition, any employee relationships that continue (or covenants not to compete that are entered into) as part of the transfer of assets would be taken into account in determining whether the transferred assets constitute a trade or business or a substantial portion of a trade or business.

Interests in a corporation, partnership, trust, or estate.—The term "section 197 intangible" would not include any interest in a corporation, partnership, trust, or estate. Thus, for example, the bill would not apply to the cost of acquiring stock, partnership inter-

ests, or interests in a trust or estate, whether or not such interests are regularly traded on an established market.[76]

Interests under certain financial contracts.—The term "section 197 intangible" would not include any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract, whether or not such interest is regularly traded on an established market. Any interest under a mortgage servicing contract, credit card servicing contract or other contract to service indebtedness issued by another person, and any interest under an assumption reinsurance contract [77] would not be excluded from the definition of the term "section 197 intangible" by reason of the exception for interests under certain financial contracts.

Interests in land.—The term "section 197 intangible" would not include any interest in land. Thus, the cost of acquiring an interest in land would be taken into account under present law rather than under the bill. For this purpose, an interest in land would include 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. An interest in land would not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television services.

Certain computer software.—The term "section 197 intangible" would not include computer software (whether acquired as part of a trade or business or otherwise) that (1) is readily available for purchase by the general public; (2) is subject to a non-exclusive license; and (3) has not been substantially modified. In addition, the term "section 197 intangible" would not include computer software which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

For purposes of the bill, the term "computer software" would be defined as any program (*i.e.*, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function. The term "computer software" would include any incidental and ancillary rights with respect to computer software that (1) are necessary to effect the legal acquisition of the title to, and the ownership of, the computer software, and (2) are used only in connection with the computer software. The term "computer software" would not include any data base or other similar item regardless of the form in which it is maintained or stored.

If a depreciation deduction is allowed with respect to any computer software that is not a section 197 intangible, the amount of the deduction would be determined by amortizing the adjusted basis of the computer software ratably over a 36-month period that begins with the month that the computer software is placed in service. For this purpose, the cost of any computer software that is taken into account as part of the cost of computer hardware or

[76] A temporal interest in property, outright or in trust, could not be used to convert a section 197 intangible into property that is amortizable more rapidly than ratably over the 14-year period specified in the bill.

[77] See below for a description of the treatment of assumption reinsurance contracts.

other tangible property under present law would continue to be taken into account in such manner under the bill. In addition, the cost of any computer software that is currently deductible (*i.e.*, not capitalized) under present law would continue to be taken into account in such manner under the bill.

Certain interests in films, sound recordings, video tapes, books, or other similar property.—The term "section 197 intangible" would not include any interest (including an interest as a licensee) in a film, sound recording, video tape, book, or other similar property if the interest is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

Certain rights to receive tangible property or services.—The term "section 197 intangible" would not include any right to receive tangible property or services under a contract (or any right to receive tangible property or services granted by a governmental unit or an agency or instrumentality thereof) if the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to a right to receive tangible property or services that is not a section 197 intangible, the amount of the deduction would be determined in accordance with regulations to be promulgated by the Treasury Department. It is anticipated that the regulations may provide that in the case of an amortizable right to receive tangible property or services in substantially equal amounts over a fixed period that is not renewable, the cost of acquiring the right will be taken into account ratably over such fixed period. It is also anticipated that the regulations may provide that in the case of a right to receive a fixed amount of tangible property or services over an unspecified period, the cost of acquiring such right will be taken into account under a method that allows a deduction based on the amount of tangible property or services received during a taxable year compared to the total amount of tangible property or services to be received.

For example, assume that a taxpayer acquires from another person a favorable contract right of such person to receive a specified amount of raw materials each month for the next three years (which is the remaining life of the contract) and that the right to receive such raw materials is not acquired as part of the acquisition of assets that constitute a trade or business or a substantial portion thereof (*i.e.*, such contract right is not a section 197 intangible). It is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right ratably over the three-year remaining life of the contract. Alternatively, if the favorable contract right is to receive a specified amount of raw materials during an unspecified period, it is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right by multiplying such cost by a fraction, the numerator of which is the amount of raw materials received under the contract during any taxable year and the denominator of which is the total amount of raw materials to be received under the contract.

It is also anticipated that the regulations may require a taxpayer under appropriate circumstances to amortize the cost of acquiring a renewable right to receive tangible property or services over a period that includes all renewal options exercisable by the taxpayer at less than fair market value.

Certain interests in patents or copyrights.—The term "section 197 intangible" would not include any interest in a patent or copyright which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to an interest in a patent or copyright and the interest is not a section 197 intangible, then the amount of the deduction would be determined in accordance with regulations to be promulgated by the Treasury Department. It is anticipated that the regulations may provide that if the purchase price of a patent is payable on an annual basis as a fixed percentage of the revenue derived from the use of the patent, then the amount of the depreciation deduction allowed for any taxable year with respect to the patent would equal the amount of the royalty paid or incurred during such year.[78]

Interests under leases of tangible property.—The term "section 197 intangible" would not include any interest as a lessor or lessee under an existing lease of tangible property (whether real or personal).[79] The cost of acquiring an interest as a lessor under a lease of tangible property where the interest as lessor is acquired in connection with the acquisition of the tangible property would be taken into account as part of the cost of the tangible property. For example, if a taxpayer acquires a shopping center that is leased to tenants operating retail stores, the portion (if any) of the purchase price of the shopping center that is attributable to the favorable attributes of the leases would be taken into account as a part of the basis of the shopping center and would be taken into account in determining the depreciation deduction allowed with respect to the shopping center.

The cost of acquiring an interest as a lessee under an existing lease of tangible property would be taken into account under present law (see section 178 of the Code and Treas. Reg. sec. 1.162-11(a)) rather than under the provisions of the bill.[80] In the case of any interest as a lessee under a lease of tangible property that is acquired with any other intangible property (either in the same transaction or series of related transactions), however, the portion of the total purchase price that is allocable to the interest as a lessee could not exceed the excess of (1) the present value of the fair market value rent for the use of the tangible property for the term of the lease,[81] over (2) the present value of the rent reason-

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[78] See *Associated Patentees, Inc.*, 4 T.C. 979 (1945); and Rev. Rul. 67-136, 1967-1 C.B. 58.

[79] A sublease would be treated in the same manner as a lease of the underlying property. Thus, the term "section 197 intangible" would not include any interest as a sublessor or sublessee of tangible property.

[80] The lease of a gate at an airport for the purpose of loading and unloading passengers and cargo would be considered a lease of tangible property for this purpose. It is anticipated that such treatment will serve as guidance to the Internal Revenue Service and taxpayers in resolving past disputes.

[81] In no event could the present value of the fair market value rent for the use of the tangible property for the term of the lease exceed the fair market value of the tangible property as of the

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ably expected to be paid for the use of the tangible property for the term of the lease.

Interests under indebtedness.—The term "section 197 intangible" would not include any interest (whether as a creditor or debtor) under any indebtedness that was in existence on the date that the interest was acquired.[82] Thus, for example, the value of assuming an existing indebtedness with a below-market interest rate would be taken into account under present law rather than under the bill. In addition, the premium paid for acquiring the right to receive an above-market rate of interest under a debt instrument may be taken into account under section 171 of the Code, which generally allows the amount of the premium to be amortized on a yield-to-maturity basis over the remaining term of the debt instrument. This exception for interests under existing indebtedness would not apply to the deposit base and other similar items of a financial institution.

Professional sports franchises.—The term "section 197 intangible" would not include a franchise to engage in professional baseball, basketball, football, or other professional sport, and any item acquired in connection with such a franchise. Consequently, the cost of acquiring a professional sports franchise and related assets (including any goodwill, going concern value, or other section 197 intangibles) would be allocated among the assets acquired as provided under present law (see, for example, section 1056 of the Code) and would be taken into account under the provisions of present law.

Exception for certain self-created intangibles

The bill generally would not apply to any section 197 intangible that is created by the taxpayer if the section 197 intangible is not created in connection with a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion thereof.

For purposes of this exception, a section 197 intangible that is owned by a taxpayer would be considered created by the taxpayer if the intangible is produced for the taxpayer by another person under a contract with the taxpayer that is entered into prior to the production of the intangible. For example, a technological process or other know-how that is developed specifically for a taxpayer under an arrangement with another person pursuant to which the taxpayer retains all rights to the process or know-how would be considered created by the taxpayer.

The exception for "self-created" intangibles would not apply to the entering into (or renewal of) a contract for the use of a section 197 intangible. Thus, for example, the exception would not apply to the capitalized costs incurred by a licensee in connection with the entering into (or renewal of) a contract for the use of know-how or

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date of acquisition. The present value of such rent would be presumed to be less than the value of the tangible property if the duration of the lease is less than the economic useful life of the property.

[82] For purposes of this exception, the term "interest under any existing indebtedness" would include mortgage servicing rights to the extent that the rights are stripped coupons under section 1286 of the Code. See Rev. Rul. 91-46, 1991-34 I.R.B. 5 (August 26, 1991).

other section 197 intangible. These capitalized costs would be amortized over the 14-year period specified in the bill.

In addition, the exception for "self-created" intangibles would not apply to: (1) any license, permit, or other right that is granted by a governmental unit or an agency or instrumentality thereof; (2) any covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (3) any franchise, trademark, or trade name. Thus, for example, the capitalized costs incurred in connection with the development or registration of a trademark or trade name would be amortized over the 14-year period specified in the bill.

Special rules

Determination of adjusted basis

The adjusted basis of a section 197 intangible that is acquired from another person generally would be determined under the principles of present law that apply to tangible property that is acquired from another person. Thus, for example, if a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible would be increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount would be amortized ratably over the remaining months in the 14-year amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.

Treatment of certain dispositions of amortizable section 197 intangibles

Special rules would apply if a taxpayer disposes of a section 197 intangible that was acquired in a transaction or series of related transactions and, after the disposition,[83] the taxpayer retains other section 197 intangibles that were acquired in such transaction or series of related transactions.[84] First, no loss would be recognized by reason of such a disposition. Second, the adjusted bases of the retained section 197 intangibles that were acquired in connection with such transaction or series of related transactions would be increased by the amount of any loss that is not recognized. The adjusted basis of any such retained section 197 intangible would be increased by the product of (1) the amount of the loss that is not recognized solely by reason of this provision, and (2) a fraction, the numerator of which is the adjusted basis of the intangible as of the date of the disposition and the denominator of which is the total

[83] For this purpose, the abandonment of a section 197 intangible or any other event that renders a section 197 intangible worthless would be considered a disposition of a section 197 intangible.

[84] These special rules would 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. In no event, however, would the termination or worthlessness of a portion of a section 197 intangible be considered the disposition of a separately acquired section 197 intangible. For example, the termination of one or more customers from an acquired customer list or the worthlessness of some information from an acquired data base would not be considered the disposition of a separately acquired section 197 intangible.

adjusted bases of all such retained section 197 intangibles as of the date of the disposition.

For purposes of these rules, all persons treated as a single taxpayer under section 41(f) of the Code would be treated as a single taxpayer. Thus, for example, a loss would not 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. It is anticipated that the Treasury Department will provide rules for taking into account the amount of any loss that is not recognized due to this rule (for example, by allowing the corporation that disposed of the section 197 intangible to amortize the loss over the remaining portion of the 14-year amortization period).

Treatment of certain nonrecognition transactions

If any section 197 intangible is acquired in a transaction to which section 332, 351, 361, 721, 731, 1031, or 1033 of the Code applies (or any transaction between members of the same affiliated group during any taxable year for which a consolidated return is filed),[85] the transferee would be treated as the transferor for purposes of applying this provision with respect to the amount of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor.

For example, assume that an individual owns an amortizable section 197 intangible that has been amortized under section 197 for 4 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 would be amortized over the 10 years remaining in the original 14-year amortization period for the transferred asset and the other $100,000 of basis would be amortized over the 14-year period specified in the bill.[86]

Treatment of certain partnership transactions

Generally, consistent with the rules described above for certain nonrecognition transactions, a transaction in which a taxpayer acquires an interest in an intangible held through a partnership (either before or after the transaction) would be treated as an acquisition to which the bill applies only if, and to the extent that, the acquiring taxpayer obtains, as a result of the transaction, an increased basis for such intangible.[87]

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[85] The termination of a partnership under section 708(b)(1)(B) of the Code would be a transaction to which this rule applies. In such a case, the bill would apply only to the extent that the adjusted basis of the section 197 intangibles before the termination exceeds the adjusted basis of the section 197 intangibles after the termination. (See the example below in the discussion of "Treatment of certain partnership transactions.")

[86] No inference is intended whether any asset treated as a section 197 intangible under the bill is eligible for like kind exchange treatment.

[87] This discussion is subject to the application of the anti-churning rules which are discussed below.

For example, assume that A, B and C each contribute $700 for equal shares in partnership P, which on January 1, 1993, acquires as its sole asset an amortizable section 197 intangible for $2,100. Assume that on January 1, 1997, (1) the sole asset of P is the intangible acquired in 1993, (2) the intangible has an unamortized basis of $1,500 and A, B, and C each have a basis of $500 in their partnership interests, and (3) D (who is not related to A, B, or C) acquires A's interest in P for $800. Under the bill, if there is no section 754 election in effect for 1997, there would be no change in the basis or amortization of the intangible and D would merely step into the shoes of A with respect to the intangible. D's share of the basis in the intangible would be $500, which would be amortized over the 10 years remaining in the amortization period for the intangible.

On the other hand, if a section 754 election is in effect for 1997, then D would be treated as having an $800 basis for its share of P's intangible. Under section 197, D's share of income and loss would be determined as if P owns two intangible assets. D would be treated as having a basis of $500 in one asset, which would continue to be amortized over the 10 remaining years of the original 14-year life. With respect to the other asset, D would be treated as having a basis of $300 (the amount of step-up obtained by D under section 743 as a result of the section 754 election) which would be amortized over a 14-year period starting with January of 1997. B and C would each continue to share equally in a $1,000 basis in the intangible and amortize that amount over the remaining 10-year life.

As an additional example, assume the same facts as described above, except that D acquires both A's and B's interests in P for $1,600. Under section 708, the transaction is treated as if P is liquidated immediately after the transfer, with C and D each receiving their pro rata share of P's assets which they then immediately contribute to a new partnership. The distributions in liquidation are governed by section 731. Under the bill, C's interest in the intangible would be treated as having a $500 basis, with a remaining amortization period of 10 years. D would be treated as having an interest in two assets: one with a basis of $1,000 and a remaining amortization period of 10 years, and the other with a basis of $600 and a new amortization period of 14 years.

The bill would also change the treatment of payments made in liquidation of the interest of a deceased or retired partner in exchange for goodwill. Except in the case of payments made on the retirement or death of a general partner of a partnership for which capital is not a material income-producing factor, such payments would not be treated as a distribution of partnership income. Under the bill, however, if the partnership makes an election under section 754, section 734 would generally provide the partnership the benefit of a stepped-up basis for the retiring or deceased partner's share of partnership goodwill and an amortization deduction for the increase in basis under section 197.

For example, using the facts from the preceding examples, assume that on January 1, 1997, A retires from the partnership in exchange for a payment from the partnership of $800, all of which is in exchange for A's interest in the intangible asset owned by P. Under the bill, if there is a section 754 election in effect for 1997, P

would be treated as having two amortizable section 197 intangibles: one with a basis of $1,500 and a remaining life of 10 years, and the other with a basis of $300 and a new life of 14 years.

Treatment of certain reinsurance transactions

The bill would apply to any insurance contract that is acquired from another person through an assumption reinsurance transaction (but not through an indemnity reinsurance transaction).[88] The amount taken into account as the adjusted basis of such a section 197 intangible, however, would equal the excess of (1) the amount paid or incurred by the acquirer/reinsurer under the assumption reinsurance transaction,[89] over (2) the amount of the specified policy acquisition expenses (as determined under section 848 of the Code) that is attributable to premiums received under the assumption reinsurance transaction. The amount of the specified policy acquisition expenses of an insurance company that is attributable to premiums received under an assumption reinsurance transaction would be amortized over the period specified in section 848 of the Code.

Treatment of amortizable section 197 intangible as depreciable property

For purposes of chapter 1 of the Internal Revenue Code, an amortizable section 197 intangible would be treated as property of a character which is subject to the allowance for depreciation provided in section 167. Thus, for example, an amortizable section 197 intangible would not be a capital asset for purposes of section 1221 of the Code, but an amortizable section 197 intangible held for more than one year generally would qualify as property used in a trade or business for purposes of section 1231 of the Code. As further examples, an amortizable section 197 intangible would constitute section 1245 property, and section 1239 of the Code would apply to any gain recognized upon the sale or exchange of an amortizable section 197 intangible, directly or indirectly, between related persons.

Treatment of certain amounts that are properly taken into account in determining the cost of property that is not a section 197 intangible

The bill would not apply to any amount that is properly taken into account under present law in determining the cost of property that is not a section 197 intangible. Thus, for example, no portion of the cost of acquiring real property that is held for the production of rental income (for example, an office building, apartment building or shopping center) would be taken into account under the bill (*i.e.*, no goodwill, going concern value or any other section 197 intangible would arise in connection with the acquisition of such real

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[88] An assumption reinsurance transaction is an arrangement whereby one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company). In addition, for purposes of the bill, an assumption reinsurance transaction would include any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338 of the Code.

[89] The amount paid or incurred by the acquirer/reinsurer under an assumption reinsurance transaction would be determined under the principles of present law. See Treas. Reg. sec. 1.817-4(d)(2).

property). Instead, the entire cost of acquiring such real property would be included in the basis of the real property and would be recovered under the principles of present law applicable to such property.

Modification of purchase price allocation and reporting rules for certain asset acquisitions

Sections 338(b)(5) and 1060 of the Code authorize the Treasury Department to promulgate regulations that provide for the allocation of purchase price among assets in the case of certain asset acquisitions. Under regulations that have been promulgated pursuant to this authority, the purchase price of an acquired trade or business must be allocated among the assets of the trade or business using the "residual method."

Under the residual method specified in the Treasury regulations, all assets of an acquired trade or business are divided into the following four classes: (1) Class I assets, which generally include cash and cash equivalents; (2) Class II assets, which generally include certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency; (3) Class III assets, which generally include all assets other than those included in Class I, II, or IV (generally all furniture, fixtures, land, buildings, equipment, other tangible property, accounts receivable, covenants not to compete, and other amortizable intangible assets); and (4) Class IV assets, which include intangible assets in the nature of goodwill or going concern value. The purchase price of an acquired trade or business (as first reduced by the amount of the assets included in Class I) is allocated to the assets included in Class II and Class III based on the value of the assets included in each class. To the extent that the purchase price (as reduced by the amount of the assets in Class I) exceeds the value of the assets included in Class II and Class III, the excess is allocable to assets included in Class IV.

It is expected that the present Treasury regulations which provide for the allocation of purchase price in the case of certain asset acquisitions will be amended to reflect the fact that the bill allows an amortization deduction with respect to intangible assets in the nature of goodwill and going concern value. It is anticipated that the residual method specified in the regulations will be modified to treat all amortizable section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which the bill applies.

Section 1060 also authorizes the Treasury Department to require the transferor and transferee in certain asset acquisitions to furnish information to the Treasury Department concerning the amount of any purchase price that is allocable to goodwill or going concern value. The bill provides that the information furnished to the Treasury Department with respect to certain asset acquisitions is to specify the amount of purchase price that is allocable to amortizable section 197 intangibles rather than the amount of purchase price that is allocable to goodwill or going concern value. In addition, it is anticipated that the Treasury Department will exercise its existing regulatory authority to require taxpayers to furnish such additional information as may be necessary or appropriate to

carry out the provisions of the bill, including the amount of purchase price that is allocable to intangible assets that are not amortizable section 197 intangibles.

Regulatory authority

The Treasury Department would be authorized to prescribe such regulations as may be appropriate to carry out the purposes of the bill including such regulations as may be appropriate to prevent avoidance of the purposes of the bill through related persons or otherwise. It is anticipated that the Treasury Department will exercise its regulatory authority where appropriate to clarify the types of intangible property that constitute section 197 intangibles.

Effective Date

In general

Section 4501 of H.R. 4210 generally would apply to property acquired after the date of enactment of the bill. As more fully described below, however, a taxpayer would be allowed to elect to apply the bill to either (1) all property acquired after July 25, 1991, or (2) all property acquired in certain taxable years for which the statute of limitations for the assessment of tax has not expired. In addition, a taxpayer would be allowed to elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill pursuant to a binding written contract in effect on February 14, 1992. Finally, special "anti-churning" rules would apply to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill would apply.

Election to apply bill to property acquired after July 25, 1991

A taxpayer would be allowed to elect to apply the bill to all property acquired by the taxpayer after July 25, 1991. If a taxpayer makes this election, the bill would also apply to all property acquired after July 25, 1991, by any taxpayer that is under common control with the electing taxpayer (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code) at any time during the period that begins on November 22, 1991, and that ends on the date that the election is made.[90]

The election would be made at such time and in such manner as may be specified by the Treasury Department,[91] and the election

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[90] An amortization deduction would not be allowed under the bill, however, for goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill if: (1) the section 197 intangible is acquired after July 25, 1991; and (2) either (a) the taxpayer or a related person held or used the intangible on July 25, 1991; (b) the taxpayer acquired the intangible from a person that held such intangible on July 25, 1991, and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible on July 25, 1991. (See below for a more detailed description of these "anti-churning" rules.)

[91] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the date of enactment of the bill.

could be revoked only with the consent of the Treasury Department.

Election to apply bill to property acquired during certain open taxable years

A taxpayer would be allowed to elect to apply the bill to all property acquired by the taxpayer in any taxable year for which the statute of limitations for the assessment of tax has not expired as of July 25, 1991 (other than a taxable year that occurs before a taxable year for which the statute of limitations for the assessment of tax has expired as of July 25, 1991).[92] If a taxpayer makes this election, the bill would also apply to all property acquired during any such open taxable year of any other taxpayer that is under common control with the electing taxpayer (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code) at any time during the period that begins on November 22, 1991, and that ends on the date that the election is made.

In the case of any section 197 intangible that was acquired by an electing taxpayer (or a person under common control with the electing taxpayer) on or before the date of enactment of the bill, the adjusted basis of the intangible would be amortized ratably over a 17-year period that begins with the month that the intangible was acquired.[93] An electing taxpayer (as well a person under common control with an electing taxpayer) would be required to pay interest on any deficiency that arises as a result of the election. The IRS, however, would not be required to pay interest on any refund that is payable as a result of the election. In addition, the statute of limitations on the assessment of tax and a claim for refund of tax for any open taxable year to which the election applies would not expire any sooner than two years after the date of the election.

The bill would also provide a special rule for property that is acquired by certain electing taxpayers in certain taxable years for which the statute of limitations has expired as of July 25, 1991. If (1) an "open taxable year" election applies to a taxpayer, (2) the taxpayer and the IRS have agreed on the treatment of an acquired intangible for a taxable year to which the "open taxable year" election does not apply, and (3) as of February 14, 1992, there was a dispute between the taxpayer and the IRS that arose because the IRS took a position with respect to an open taxable year that was contrary to that specified in the agreement with respect to the treatment of the acquired intangible, then the taxpayer would be

[92] The statute of limitations for a taxable year would be treated as expired for purposes of this election if, as of July 25, 1991, the statute of limitations for such taxable year is extended solely with respect to issues that do not involve the proper treatment for Federal income tax purposes of acquired intangibles that are defined as section 197 intangibles under the bill.

[93] An amortization deduction would not be allowed under the bill, however, for goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill if: (1) the section 197 intangible is acquired after July 25, 1991; and (2) either (a) the taxpayer or a related person held or used the intangible on July 25, 1991; (b) the taxpayer acquired the intangible from a person that held such intangible on July 25, 1991, and, as part of the transaction, the user of the intangible did not change; or (c) the taxpayer granted the right to use the intangible to a person (or a person related to such person) that held or used the intangible on July 25, 1991. (See below for a more detailed description of these "anti-churning" rules.)

allowed to amortize such intangible in accordance with the agreement between the taxpayer and the IRS.

The "open taxable year" election would be made at such time and in such manner as may be specified by the Treasury Department,[94] and the election could be revoked only with the consent of the Treasury Department.

Elective binding contract exception

A taxpayer would also be allowed to elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill if the property is acquired pursuant to a binding written contract that was in effect on February 14, 1992, and at all times thereafter until the property is acquired. This election could not be made by any taxpayer that is subject to either of the elections described above that would apply the provisions of the bill to property acquired before the date of enactment of the bill.

The election would be made at such time and in such manner as may be specified by the Treasury Department,[95] and the election could be revoked only with the consent of the Treasury Department.

Anti-churning rules

Special rules are provided by the bill to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill would apply.

Under these "anti-churning" rules, goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill could not be amortized as an amortizable section 197 intangible if: (1) the section 197 intangible is acquired by a taxpayer after the date of enactment of the bill; and (2) either (a) the taxpayer or a related person held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill; (b) the taxpayer acquired the intangible from a person that held such intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill. The anti-churning rules, however, would not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a) (relating to property acquired from a decedent).

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[94] It is anticipated that Treasury Department will require the election to be made by the due date of the return for the taxable year that includes the date of enactment of the bill.

[95] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the date of enactment of the bill.

For purposes of the anti-churning rules, a person would be related to another person if: (1) the person bears a relationship to that person which would be specified in section 267(b)(1) or 707(b)(1) of the Code if those sections were amended by substituting 20 percent for 50 percent; or (2) the persons are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code). A person would be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

In addition, in determining whether the anti-churning rules apply with respect to any increase in the basis of partnership property under section 732, 734, or 743 of the Code, the determinations would be made at the partner level and each partner would be treated as having owned or used the partner's proportionate share of the partnership property. Thus, for example, the anti-churning rules would not apply to any increase in the basis of partnership property that occurs upon the acquisition of an interest in a partnership that has made a section 754 election if the person acquiring the partnership interest is not related to the person selling the partnership interest.[96]

The bill also contains a general anti-abuse rule that would apply to any section 197 intangible that is acquired by a taxpayer from another person. Under this rule, a section 197 intangible could not be amortized under the provisions of the bill if the taxpayer acquired the intangible in a transaction one of the principal purposes of which is to (1) avoid the requirement that the intangible be acquired after the date of enactment of the bill or (2) avoid any of the anti-churning rules described above that are applicable to goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill.

Finally, the special rules described above that apply in the case of a transactions described in section 332, 351, 361, 721, 731, 1031, or 1033 of the Code would also apply for purposes of the effective date. Consequently, if the transferor of any section 197 property is not allowed an amortization deduction with respect to such property under this provision, then the transferee would not be allowed an amortization deduction under this provision to the extent of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor. In addition, this provision would apply to any subsequent transfers of any such property in a transaction described in section 332, 351, 361, 721, 731, 1031, or 1033.

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[96] In addition to these rules, it is anticipated that rules similar to the anti-churning rules under section 168 of the Code will apply in determining whether persons are related. See Prop. Treas. Reg. 1.168-4 (February 16, 1984). For example, it is anticipated that a corporation, partnership, or trust that owned or used property at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and that is no longer in existence will be considered to be in existence for purposes of determining whether the taxpayer that acquired the property is related to such corporation, partnership, or trust.

As a further example, 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 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.

B. S. 1245

Explanation of the Bill

S. 1245, as introduced by Senators Daschle and Symms on June 6, 1991, would amend section 167 of the Code to provide that if a taxpayer demonstrates through any reasonable method that (1) customer base, market share, or any other similar intangible item has an ascertainable value that is separate and distinct from other assets (including goodwill and going concern value) acquired as part of the same transaction, and (2) the intangible item has a limited useful life which can be reasonably estimated, then the basis of the intangible shall be amortized over such useful life.

In addition, S. 1245 would grant the Treasury Department the authority to promulgate regulations establishing safe harbor useful lives for specific classes of customer base, market share, or other similar intangible items which are generally consistent with the actual useful lives for the items within such classes. In addition, the Treasury Department would be authorized to promulgate regulations concerning the manner in which such intangible items may be valued separately and distinctly from other assets (including goodwill and going concern value).

Effective Date

S. 1245 would apply to all open taxable years (i.e., all taxable years for which the statute of limitations has not expired).

IV. ISSUES REGARDING THE FEDERAL INCOME TAX TREATMENT OF INTANGIBLE ASSETS

A. Treatment of Intangible Assets in General

Theoretically, any decline in the values of both tangible and intangible assets should be reflected in the measurement of taxable income derived from a trade or business. More accurate measures of the declines (and increases as well) in the values of assets would lead to more accurate measures of taxable income. Generally, the most accurate method of measuring taxable income would involve marking the value of the tangible or intangible assets to market each accounting period. However, such an approach would involve difficulties in identifying accurate values, particularly for assets that are not regularly traded. In addition, a mark-to-market system would involve significant complexity and compliance burdens.

Instead, depreciation or amortization allowances are typically determined based on an approximation of the expected decline in the value of the assets used in a trade or business. Theoretically, the most accurate of these schedules for both tangible and intangible assets would be unique to each business, so that different taxpayers would have different schedules for identical assets.[97] However, the use of a taxpayer-by-taxpayer facts and circumstances determination of depreciation for Federal income tax purposes has resulted in numerous disputes between taxpayers and the Internal Revenue Service.[98]

In accounting for the decline in value of an asset, it is generally necessary to identify three items: valuation (or cost), useful life, and rate of decline in value. Some tangible assets trade in markets on a stand-alone basis, allowing reasonably well-settled, unbiased estimates of the market value for those tangible assets not acquired on a stand-alone basis.[99] In addition, tangible assets are often relatively easy to classify into homogeneous groups, which may be treated in a like manner. If there is an active secondary market for tangible assets, it is possible to observe the decline in the market prices of representative assets. This, in turn, permits objective estimates to be made of the useful life and the schedule of economic decline for these assets. Such schedules can be used as a basis for providing depreciation schedules for similar assets for Federal income tax purposes and to provide certainty to taxpayers

[97] For example, a truck rented on a weekly basis to multiple users would likely experience a different pattern of decline in economic value than a similar truck used solely by an owner-operator in a wholesale business.

[98] See H. Rept. No. 1337, 83rd Cong., 2nd Sess. 22 (1954) for a discussion of the controversies surrounding the interpretation of "reasonable allowance for depreciation."

[99] Note that it is rather easy to value single assets acquired on a stand-alone basis by simply looking at the price paid by a willing buyer to a willing seller. However, defining exactly what constitutes a single asset (e.g., the bundle of property rights that makes up a single asset) and defining what constitutes a stand-alone acquisition may be difficult in particular situations.

as to the amount of depreciation deductions allowable for any asset for any taxable period.[100]

In contrast, intangible assets have often been considered harder to classify into homogeneous groups because the decline in value of these assets depends to a large extent on the particular trade or business in which the assets are used. Moreover, the valuation of intangible assets is problematic because competitive markets for these assets frequently do not exist. The lack of a market for either new or used intangible assets generally means that it is not possible to observe the decline in market prices as a means to determine the useful life or the schedule of decline in the economic value for these assets.[101] This difference from tangible assets could arguably justify a different treatment for cost recovery purposes.[102]

B. Treatment of Goodwill and Going Concern Value

The two legislative proposals differ in the scope of the assets they address. The principal difference involves the treatment of goodwill and going concern value (hereinafter together referred to as "goodwill"). As discussed in Part II above, goodwill is not amortizable under present law. S. 1245 would retain the present-law treatment of goodwill, but would provide that a customer-based intangible asset is amortizable if the taxpayer demonstrates through any reasonable method that (1) the asset has an ascertainable value that is separate and distinct from other assets (including goodwill) acquired as part of the same transaction and (2) the asset has a limited useful life that can be reasonably estimated. Section 4501 of H.R. 4210, on the other hand, would allow taxpayers to amortize the cost of acquired goodwill in the same manner and over the same period as other acquired intangible assets.

One consideration to be taken into account in determining whether goodwill should be amortized for Federal income tax purposes is whether the amortization of goodwill would provide a more accurate measure of economic income.

It may be argued that goodwill is not a wasting asset and, thus, amortization deductions should not be allowed with respect to goodwill. Alternatively, it may be argued that as long as current deductions are allowed for the costs associated with maintaining the value of goodwill, the amortization of the costs of acquired goodwill is not required in order to provide an accurate measure of economic income. For example, assume that a taxpayer acquires all the assets of a business, one of which is goodwill. Further, assume that the taxpayer engages in advertising and incurs other expenditures in the operation of its business that in part preserve the value of this goodwill.

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[100] See, e.g., Rev. Proc. 87-56, 1987-2 C.B. 674, for the class lives and recovery periods for various tangible assets and Rev. Proc. 87-57, 1987-2 C.B. 687, for the depreciation allowances provided for tangible assets of various recovery periods.

[101] Further discussion of problems encountered in the valuation of intangible assets may be found in "A Study of Intercompany Pricing," the 1988 Treasury White Paper.

[102] Under present law, the costs of tangible and intangible assets are recovered differently. The costs of tangible assets generally are recovered pursuant to the lives, methods, and conventions prescribed by section 168. However, the costs of amortizable intangible assets generally are recovered pursuant to methods and periods established as appropriate on the basis of the facts and circumstances of the taxpayers holding such assets.

Under present law, the amortization of the acquired goodwill is not allowed while the advertising and other business expenses are currently deductible. It may be argued that income is properly measured under present law because although goodwill may be a wasting asset, the currently deducted costs restore the value of the goodwill. The basis for this argument is that theoretically expenses attributable to replacing goodwill should be capitalized and amortized over the life of the goodwill and that as long as this is not required, denying amortization for goodwill is appropriate even if goodwill is a wasting asset.

On the other hand, it may be argued that goodwill is, in fact, a wasting asset and, thus, should be treated as such for Federal income tax purposes. For example, goodwill has been defined as "the expectancy of continued patronage," [103] or "the expectancy that the old customers will resort to the old place." [104] Clearly a business that has loyal customers is more valuable than a business that does not. However, this customer loyalty cannot reasonably be expected to last forever as customers relocate or die, or have needs or tastes that change over time.[105] Customer loyalty would also be expected to decline faster if a business does not take steps to continue to satisfy existing or changing customer needs (*e.g.*, by maintaining or expanding its level of service). It may be argued that goodwill is not amortizable under present law principally because taxpayers cannot overcome their burden of showing over what period goodwill wastes. Thus, specifying a recovery period for the cost of goodwill is arguably appropriate in that it would provide a measure of "rough justice."

It may further be argued that permitting the deduction of costs that may contribute to the replacement of diminishing goodwill does not justify denying a deduction for goodwill. Both creators and purchasers of businesses with goodwill deduct ordinary and necessary business expenses currently and there would be significant administrative and other issues involved in attempting to identify costs to be capitalized as contributing to the creation or replacement of goodwill. Permitting a deduction for goodwill arguably would more nearly equalize the treatment of the creator and the purchaser of goodwill than does present law.

In addition, it may be argued that the amortization of goodwill is necessary to obtain the greatest degree of simplification in the tax treatment of intangible assets. Under present law, upon the acquisition of the assets of a trade or business, a taxpayer has a tax incentive to allocate as little of the purchase price of the business as possible to goodwill. This incentive has resulted in taxpayers undertaking costly and time-consuming appraisals in order to identify, allocate purchase price to, amortize, and defend the amortization of, intangible assets other than goodwill even if these other assets have characteristics similar to goodwill.[106] Similar burdens

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[103] *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962).

[104] *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1962).

[105] Those who believe that goodwill is a wasting asset point out that U.S. financial accounting rules require goodwill to be amortized. See Accounting Principles Board Opinion No. 17, requiring amortization over no more than 40 years.

[106] See, for example, the discussion in *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3rd Cir. 1991), *cert. granted* April 6, 1992, which compares goodwill to customer lists.

are imposed on the Internal Revenue Service in connection with the examination of income tax returns that claim amortization deductions for the costs of acquired intangible assets.

By not changing the present-law treatment of goodwill, S. 1245 would retain the incentive to allocate as little of the purchase price of an acquired trade or business as possible to goodwill. By allowing amortization for goodwill and other assets over the same period, section 4501 of H.R. 4210 would significantly lessen the incentive of taxpayers to identify assets distinct from goodwill in an attempt to obtain more favorable amortization. In some cases there may still be some incentive for taxpayers to allocate value to those identifiable assets that might be disposed of separately after an acquisition, in order to minimize any gain on such a disposition. However, the identification of amortization periods for any such assets would no longer be an issue.[107]

C. Determination of the Amortization Period and Method for Intangible Assets

Both legislative proposals address the issue of whether the cost of intangible assets may be amortized, and, if so, over what period and under what method. S. 1245 provides that customer-based or other similar intangible assets would be amortized over the useful life of the asset if a value separate from goodwill can be established. In addition, under S. 1245, the Treasury Department would be granted regulatory authority to promulgate safe-harbor recovery periods consistent with industry practice and experience for the types of intangible assets to which the bill applies. Section 4501 of H.R. 4210 provides that all intangible assets to which the bill applies would be amortized over a 14-year period using a straight-line method.

Assuming that amortization deductions are allowed for the cost of some or all intangible assets, issues arise with respect to the length of the period over which these deductions should be allowed and the method to be used (*i.e.*, should amortization be on a straight-line method over the period or should it follow a more accelerated pattern). Specifically, issues arise as to whether the recovery period and method for an intangible asset should be (1) based on the taxpayer's particular facts and circumstances, (2) determined pursuant to specific lives and methods provided by statute or regulations for various classes of similar types of intangible assets, or (3) a single life and method applicable to all or most intangible assets.

Facts and circumstances determination

The principal argument in favor of a facts and circumstances determination is that this method may provide the most accurate means of measuring income. It may be argued that the use of a single recovery period and method for all intangibles is arbitrary and, depending upon the length of the period and the method selected, results in some assets being amortized too quickly while

[107] Neither of the proposals would address issues regarding allocations between intangible assets and tangible assets.

others are amortized too slowly. It may also be argued that recovery periods developed pursuant to Treasury studies would likewise be somewhat arbitrary in that they would tend to average the experience of many taxpayers, where such averaging may not be reflect the situation of a particular taxpayer. For example, a customer list in an industry that undergoes frequent product innovations may have a life that is significantly different than a customer list that involves a standard product or service.

Specific separate recovery periods and methods for different assets

The adoption of specific recovery periods and methods for different types of intangible assets would follow the approach of the present-law system for tangible property. It may be argued that such a system, while admittedly not exact, could be designed to provide a reasonably appropriate matching of the cost of an asset to the periods over which it is used.[108] On the other hand, the identification of appropriate classes of intangible assets and appropriate amortization schedules could be extremely difficult, given the diversity of intangible assets that taxpayers have identified, the variety of valuation methods that have been used, and the frequent lack of comparables in the case of many intangible assets. In addition, it may be argued that to the extent any specific schedules permitted more rapid amortization for one class of assets than another, there would still be an incentive for taxpayers to allocate value to the asset with the more rapid amortization. Such allocations could be particularly difficult to police or challenge in the absence of readily identifiable market values for these assets.

Single recovery period and method

The use of a single recovery period and method for all or most intangible assets may be criticized as arbitrary. Assets that have been amortized over a longer period than the specified method under present law arguably would receive unduly favorable treatment, while assets that have been amortized over a shorter period under present law arguably would receive unduly harsh treatment.

On the other hand, it may be argued that the present-law use of taxpayer-specific facts and circumstances has resulted in conflicting results in apparently similar cases, a situation which also could be criticized as arbitrary. Furthermore, from a simplification standpoint, it may be argued that only a single recovery period can significantly reduce the number of amortization disputes between the IRS and taxpayers.[109]

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[108] See e.g., the GAO Report, n. 26, suggesting that it would be possible to design a system with different recovery periods for different types of intangible assets.

[109] Under section 4501 of H.R. 4210, taxpayers would be required to continue to identify and value certain acquired intangible assets for purposes of determining the tax consequences on subsequent disposition of the asset. Although no loss is recognized on disposition of one asset out of a group of assets, it is necessary to determine whether gain is recognized. However, separate valuation would not generally be necessary for assets that would not likely be the subject of a separate disposition, such as goodwill or many of the other separate assets that taxpayers identify under present law.

D. Retroactive Application of the Proposals

H.R. 4210

Section 4501 of H.R. 4210 generally would apply to intangible assets that are acquired after the date of enactment of the bill. A taxpayer, however, would be allowed to elect to apply the provision (using a 17-year amortization period rather than a 14-year amortization period) retroactively to all property acquired by the taxpayer in certain taxable years for which the statute of limitations for the assessment of tax has not expired as of July 25, 1991. If a taxpayer makes this election, the bill also would apply to all property acquired during any such "open taxable year" of certain taxpayers that are related to the electing taxpayer at any time between November 22, 1991, and the date of the election.

The principal argument advanced in support of the retroactive election provided by H.R. 4210 is that the election would eliminate many existing or future controversies between taxpayers and the IRS concerning the proper Federal income tax treatment of the cost of acquiring intangible assets. It is argued that the retroactive election would "free-up" the resources of taxpayers, the IRS, and the courts, which could then be applied to more productive activities. In addition, it is argued by some that the retroactive election would provide consistent results for all taxpayers that make the election and, as such, would be fairer than present law.

On the other hand, it is argued by others that the retroactive election is unnecessary because taxpayers and the IRS are likely to settle existing controversies expeditiously due to the fact that, upon enactment of the bill, no settlement will serve as a precedent for the treatment of intangibles acquired in the future. Others argue that if the purpose of the retroactive election is to settle controversies, then the retroactive feature of the bill should be mandatory and not elective.

In addition, others observe that if the rationale for the retroactive election is to eliminate controversies between taxpayers and the IRS, then the retroactive election provided by H.R. 4210 is too broad because it would allow an amortization deduction with respect to goodwill and other similar intangible assets for which a taxpayer did not claim an amortization deduction for Federal income tax purposes. These individuals argue that if retroactive relief is provided, the relief should be limited to acquired intangible assets that the taxpayer claimed as amortizable on the original Federal income tax return for the taxable year that includes the date of the acquisition of the intangible assets.

In many cases, a taxpayer making the retroactive election will be entitled to a refund of taxes previously paid, especially where a significant portion of the purchase price of an acquired trade or business was allocated to goodwill and other intangible assets that are not amortizable for Federal income tax purposes. It is argued that if the purpose of the retroactive election is to settle controversies between taxpayers and the IRS, an electing taxpayer should not receive more favorable treatment than the treatment originally claimed on the Federal income tax return of the taxpayer. This objective can be achieved if the retroactive election is limited to acquired intangible assets that a taxpayer claimed as amortizable on

the original Federal income tax return. Furthermore, if the purpose of the retroactive election is to eliminate controversies between taxpayers and the IRS, such a limitation is justified on the grounds that there is no controversy with respect to the portion of the purchase price of an acquired trade or business that a taxpayer has treated as not amortizable for Federal income tax purposes. On the other hand, such a limitation would favor taxpayers that were aggressive in identifying intangibles that were claimed to be amortizable for Federal income tax purposes and in allocating purchase price to such intangibles.

With respect to the issue of fairness, it is believed by some that the retroactive election could provide an unjustified windfall to taxpayers that make the election. It is argued that many of the taxpayers eligible to make the election acquired a trade or business based on the assumption that the portion of the purchase price of the acquired trade or business that is allocable to goodwill and other intangible assets in the nature of goodwill would not be amortizable for Federal income tax purposes. To the extent that the purchase price of the assets was negotiated based on this assumption, the retroactive election will result in an unjustified windfall to these taxpayers.

Furthermore, with respect to the issue of fairness, the retroactive election has been criticized because it only applies to intangible assets acquired during a taxable year for which the statute of limitations on the assessment of tax has not expired.[110] While limiting the election to intangible assets acquired during taxable years for which the statute of limitations has not expired is likely to exclude taxpayers that do not have an existing (or potential future) controversy with the IRS concerning the proper Federal income tax treatment of acquired intangible assets, it may be viewed as unfair by those taxpayers that settled an IRS audit by agreeing not to amortize certain intangible assets or by agreeing to an amortization period that was, on average, greater than 17 years. In addition, the retroactive election provided by H.R. 4210 is likely to be perceived as unfair by those taxpayers with taxable years for which the statute of limitations on assessment has expired because the taxpayers paid an asserted deficiency relating to the amortization of intangible assets and filed a claim for refund.

[110] Under a special rule, an electing taxpayer that has entered into an agreement for a taxable year with the IRS, concerning the Federal income tax treatment of an intangible asset that was acquired during a taxable year for which the statute of limitations on the assessment of tax has expired, would be allowed under certain circumstances to amortize such intangible asset in accordance with the agreement in subsequent taxable years if the IRS was challenging that position for those later years. While this provision may provide some certainty for intangible asset acquisitions occurring during a closed taxable year where there is a dispute in a later taxable year, the provision has been criticized for its uneven application. The provision only applies if there is an "agreement" between the IRS and the taxpayer, yet IRS administrative practice in entering into agreements or even raising issues on audit may vary from case to case, especially if the treatment of acquired intangible assets has little or no tax effect for the closed taxable year of the agreement and both the taxpayer and the IRS assumed that the treatment of intangible assets could be raised in a subsequent taxable year for which such treatment could have a significant tax effect. In addition, this special provision only applies to taxpayers that make the general retroactive election provided by H.R. 4210. Such taxpayers must also have a separate acquisition for which the year of acquistion is still open for assesment. Furthermore, this provision also involves selectivity. Although it is directed at disputes where there was a prior year "agreement" with respect to the treatment of intangible assets acquired during a closed taxable year, it does not require the taxpayer to follow this agreement unless an election is made to do so.

Furthermore, the retroactive election provided by H.R. 4210 has been criticized because the election is likely to result in a significant loss of revenue to the Federal Government due to adverse selection. It is believed that many taxpayers making the election would be taxpayers that allocated a significant portion of the purchase price of an acquired trade or business to intangibles that would likely not be amortizable under present law or that would likely be amortizable over a period that is longer than 17 years. In addition, many of these taxpayers will become entitled to a refund of taxes previously paid. On the other hand, it is believed that many taxpayers that allocated a significant portion of the purchase price of an acquired trade or business to intangibles that are arguably amortizable under present law over a period that is shorter than 17 years would not make the election to apply the bill on a retroactive basis, even though others might do so to achieve certainty or curtail the dispute process.

Finally, it is argued that to the extent that a windfall is provided to electing taxpayers, the retroactive election provided by H.R. 4210 may reinforce the view of some that the Federal tax system favors large corporations and wealthy individuals.

S. 1245

S. 1245 would apply to taxable years beginning before, on, or after June 6, 1991 (*i.e.*, to all open taxable years). It is unclear whether S. 1245 would effectively resolve pending disputes. It still would be necessary under S. 1245 to determine whether there is an identifiable asset with a determinable life and a value separate from goodwill.

PREPARED STATEMENT OF SENATOR JOHN BREAUX

Mr. Chairman, the issue of how to treat the amortization of intangible assets has tied up the federal regulators and the courts for some time. It is time that congress review the issues and determine whether there is a statutory solution that can resolve the issues.

The primary bill before us, H.R. 3505, introduced by Chairman Rostenkowski and included in the vetoed "Tax Fairness and Economic Growth Act" (H.R. 4210), has many good points but also has many issues that need careful review.

On the good side, it tries to resolve the issues in a simple manner by applying a uniform 14 year amortization rule for all intangible assets. The bill was also revised to attempt to ensure that the 14 rule is not over-inclusive. For example, I am pleased that the intangibles provision that was made part of H.R. 4210, made clear that interest in films, sound recordings, videotapes, books or similar property were not to fall within the scope of the bill. If this committee decides to go forward on a separate track with the intangibles bill, I think it makes good sense for us to adopt that same modification. Otherwise, our intellectual property industries, a prized American trade asset, would be radically and unnecessarily disrupted.

In addition, a provision to allow retroactive applicability of this the provision of this bill would treat those who are currently caught by the current regulatory uncertainty in a fair manner. I hope that should the committee act on this bill, we can look carefully at including a provision for retroactivity.

Finally, we need to balance the need to resolve the uncertainties in the intangible asset amortization area with the need to guard against creating a new tax subsidy for future takeover activity.

PREPARED STATEMENT OF JOHN BUCKLEY

I. SUMMARY

The Committee on Taxation of Intangible Assets is an ad hoc group of heating oil marketers and associations formed for the limited propose of seeking fair treatment in any legislation concerning taxation of acquired intangible assets. The Committee includes the New England Fuel Institute ("NEFI"), the Empire State Petroleum Association ("ESPA"), the Fuel Merchants Association of New Jersey ("FMA"), the Oregon Petroleum Marketers Association ("OPMA") and many independent petroleum distributors. The heating oil industry is comprised primarily of thousands of small, mostly family owned local enterprises that are often the life's work of the owning family. NEFI, ESPA, FMA, and OPMA alone represent more than 2,000 such small heating oil marketers that are not affiliated with any integrated oil company.

The petroleum marketing industry supports the effort to simplify the taxation of acquired intangibles. Legislation on this complex subject would eliminate uncertainty and prevent countless further disputes. The uncertainty is even greater now as a result of the impending Supreme Court decision in *Newark Morning Ledger* v. *United States.* Thus, a statutory clarification this year is desirable. However, simplification and clarity can be accomplished with less arbitrary and more economically based reform. We urge the Committee to balance simplification with economic fairness for those small businesses that have asset bases largely composed of intangibles with limited useful lives.

The intangibles provisions adopted by the House would significantly decrease the value of these enterprises. The assets of retail heating oil companies, for example, consist primarily of a few delivery trucks, service vans, a small office and a list of current customers.

Most of the value of these assets to an acquiror or lender is in the customer lists and a covenant from its former owner not to compete for these customers. These two assets often represent 75 percent or more of the business. Under current law, both of these assets are amortizable over a period much shorter than 14 years, with customer lists generally declining over 6 to 9 years, and covenants over their fixed term, usually 5 years. Thus, the economically arbitrary 14-year period in H.R. 4210 diminishes the value of these assets to a purchaser. Because retail heating oil businesses have few "hard" assets and very little goodwill, this change will diminish overall value by about 10 percent. The diminution is manifested not only in sales price, but also in availability of asset based credit. This impact has no basis in tax policy or economic fairness.

Only two IRS challenges relating to heating oil customer lists have reached the courts and in both cases, *Holden Fuel Oil Co.* v. *IRS,* 479 F.2d 613 (6th Cir. 1973) and *Abco Fuel Oil* v. *Commissioner,* 46 TCM (CCH) 343 (1990), the amortizability

of the retail fuel customer list has been recognized, and rapid decline rates have been approved.[1]

The negative impact to these small businesses can be alleviated with a simple change that allows covenants not to compete to be amortized over their actual contract term, as they are under current law. This modification would permit purchasers of small businesses to amortize the value of the covenant not to compete over its actual contract term, e.g., 5 years, rather than over 14 years. To prev[illegible] any possible abuse and to limit the overall scope of the provision to small businesses, the provision could restrict the amount allocable to the covenant to 40 percent of the value of the intangible assets transferred, with an absolute maximum of $2 million. In addition, the rule could be further limited to transactions with total asset value under $10 million.

This change would preserve the assets of the heating oil dealer and similarly situated small businesses at or near current levels. It would have very little effect on revenues. In our industry, we believe the proposed modification would be approximately revenue neutral in comparison to current practice (it would be modestly revenue positive) and would cost approximately $1.6 to $2.2 million in comparison to H.R. 4210, which amount represents the annual diminution in value that would be suffered by heating oil dealers if H.R. 4210 were enacted unchanged.

II. BACKGROUND

Since 1973, amortization has been permitted for acquired intangibles that are "separate and distinct from goodwill" and which have a "determinate useful life." Because these standards are subjective and fact specific, they have lead to many disputes between taxpayers and IRS, and significant litigation. In certain areas, such as newspaper subscription lists and bank core deposits, because of differing court decisions, similarly situated taxpayers have been treated differently. The amortizability of an acquired newspaper subscription list will soon be decided definitively in *Newark Morning Ledger Co.* v. *United States,* currently pending before the Supreme Court.

While *Newark Morning Ledger* may clarify existing law in the newspaper industry, in the heating oil sector, the amortizability of customer lists has until now uniformly been approved by the courts. See *Holden Fuel Co.,* and *Abco Fuel Oil, supra.* These cases establish the amortizability of the customer list, as well as its separateness from goodwill. The IRS has uniformly allowed the amortization of these customer lists over their useful lives.

Further, there is no controversy regarding the amortizability of the value of a covenant not-to-compete. This asset may be amortized over the life of the covenant, usually about 5 years. Thus, although the IRS may disagree with the outcome, there is settled law in the heating oil industry with regard to amortization of intangibles. This relative certainty (in tax law, nothing is certain) permits accurate valuation of these assets, which is reflected in approximately 25–50 transactions per year. The thousands of small business owners in this industry and their bankers have long relied on this method for valuing these businesses.

Despite the relative certainty of the law in the heating oil sector, we recognize the need for a legislative resolution that clarifies this area. However, simplification must not ignore a basic objective of tax policy, which is to tax "net income." Amortization and depreciation are economic concepts that reflect the need to replace wasting assets; tax law has always recognized these concepts by permitting deductions of the cost of an asset over its approximate useful life. H.R. 4210 ignores this economic reality, thereby penalizing these businesses with shorter lived intangibles, and particularly injuring small businesses which are composed largely of such assets. Simplification need not be so arbitrary in its consequences; it need not radically force all intangible assets into an ill-fitting 14 year period.

To some degree, the provisions passed by the House recognize the need to accommodate economic reality. In certain cases, the House has fashioned alternative rules for amortization of specific assets over periods much less than 14 years, without sacrificing simplicity or clarity. For example, computer software; interests in films, sound recordings, video tapes, and books; and interests related to professional sports franchises have been recognized as requiring separate treatment.While special

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[1] In *Abco,* the amortization period accepted was 5 years; in *Holden,* 75 percent of the value was amortized over 3 years, and the remainder over 15 years. Because there is no significant goodwill involved in the name or location of these businesses, these cases also approved allocations of 75 percent of the intangible value of the company to the customer list and 25 percent to goodwill. Moreover, the IRS in recent years, has approved goodwill allocations of 5 percent when the acquired company was folded into the acquiring company and 15 percent when the name of the acquired company was maintained by the acquiror.

treatment may not be possible for customer-based intangibles with useful lives less than 14 years, a clear separate rule is appropriate for fixed-term covenants not to compete in small business transactions. Fairness can be included without any loss of clarity or sacrificing the goals of H.R. 4210.

III. THE GAO REPORT

The General Accounting Office ("GAO") has conducted an extensive study on the tax treatment of intangible assets.[2] The study was specifically requested by the Joint Committee on Taxation. GAO's comprehensive review provides a useful data base and a framework for legislative revision. GAO suggests a mechanism for simplification that balances simplicity with economic reality and reflects principles of financial accounting. We urge the Committee to recognize the principles and tax policy objectives included in the GAO report as it considers changes to H.R. 4210.

Specifically, the GAO's premise is that any revision of the current tax rules should address two basic policy questions: "First, will the revision improve the matching of business expense and revenue to better reflect income for the period? Second, will the change lessen the administrative burden on the taxpayer and IRS?" (GAO Report at 32.) H.R. 4210 disregards entirely the tax policy objective of matching business expense with revenue. It focuses entirely on simplification. The selected cost recovery period—14 years—bears no relation to useful life, particularly for a fixed-term contract with an undisputed useful life.

Although there is inherent conflict between simplicity and individual fairness, it is possible to achieve both objectives by following the principles suggested in the GAO report:

> [A] comprehensive approach that categorizes intangible assets, including goodwill, and assigns a specific cost recovery period to assets is a preferable method to adopt. If this policy were adopted, intangible asset amortization deductions would be similar to the tangible asset depreciation deductions under current tax rules. This policy would be in accordance with the financial accounting standards that recognize the value of all purchased intangible assets, including goodwill, that are consumed over time. . . . (GAO Report at 33).

The recognition of more than one cost recovery period is essential to avoid economic arbitrariness and to recognize the enormous difference in useful lives for different intangibles, and the significant effects of simplification on individual taxpayers.

Whether a taxpayer will be a "winner" or "loser" depends primarily on the purely random relationship between the change in value of that taxpayer's intangible assets that are currently amortizable and its goodwill.[3] This is not a sound basis for simplifying the tax code, particularly when there has been no suggestion that goodwill declines in a period as rapidly as 14 years.

H.R. 4210 would provide a windfall to entities with substantial goodwill. As long as revenue neutrality is a condition for reform, this windfall must be paid for by taxpayers whose assets decline over periods less than 14 years and who are forced to recover the cost of these assets over the arbitrary 14 year period. The bill is not intended to have draconian effects; it should be adjusted to diminish these random yet significant effects by following more closely the economic principles for simplification articulated in the GAO Report.

IV. IMPACT OF H.R. 4210 ON A TYPICAL HEATING OIL DEALER

Although each company's tax accounting is based on its particular facts and circumstances, the proposed lengthening of the amortization period for customer lists and non-compete agreements is likely to reduce the equity of a typical small heating oil owner by more than 10 percent.

The retail heating oil industry is comprised of many thousands of small, family-owned companies who together supply well over 90 percent of the millions of residential homes and businesses heated with oil nationwide. The number of firms in the industry, and the market for heating oil, has been declining for almost 20 years. Over the last decade, approximately 25 to 50 retail companies per year have been sold by their owners to another heating oil company. In most cases, the sale was

[2] GAO/GGD—91–88 (August 12, 1991) "Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets."

[3] For some taxpayers, whose intangible assets decline over periods greater than 14 years, the bill provides a "win-win" result, offering a windfall on currently amortizable intangibles and goodwill without any economic basis.

either because the owner wished to retire or because profitability declined. Profitability is a particular problem for the smaller companies. Thus, many have been sold or will be sold.

On average, these firms' sales were about 1 to 5 million gallons each, although some were in the 10 to 20 million gallon range, for a total of approximately 100 million gallons "sold" per year. Thus, over the decade the industry has shrunk with the sale of some 250 to 500 firms whose total business was perhaps 1 billion gallons at the time of sale and whose gross sales value was $400 to $500 million.

Because a large majority of the value of every retail heating oil business lies in its customer lists and a covenant from its owner not to compete for these customers, both of which decline over periods much shorter than 14 years, the arbitrary 14-year period would diminish the current value of a heating oil business. Typically, intangibles account for about 75–80 percent of the value of a retail heating oil business, including both the customer list, the covenant not to compete and a small amount of goodwill.

In practical terms, the customer list is the only asset of a small dealer with significant market value; the covenant not to compete protects the value of this asset from a precipitous decline. Both assets have useful lives considerably shorter than 14 years; the covenant normally runs for no more than 5 years and the customer list is generally amortized over 6 to 9 years. These decline periods have been accepted by the IRS and the courts. *See, e.g., Abco Fuel Oil* v. *Comm'er,* 46 TCM 343 (1990).

The ability to amortize acquired goodwill over 14 years would only partially offset the reduction in value of a heating oil company caused by the longer period. This is because goodwill in an industry without significant name recognition or location value accounts for a very small share of the total intangible package. Goodwill generally accounts for only 5 to 25 percent of total asset value. This is because there is no location premium or brand name value; in many cases, the name of the acquired company is not even preserved. When all of these factors are assessed, the lengthening of the amortization period for the covenant not to compete and the customer list to 14 years would reduce the equity of a typical heating oil business by more than 10 percent.

This decline in value also has a serious corollary effect on a heating oil business' ability to borrow, particularly to finance purchases of heating oil during the winter season. Seasonal lines of credit are limited by a company's asset value, because these assets are the security for the loan. Thus, when asset values decline, lines of credit are reduced, particularly during periods, such as now, when all lenders are cautious. Adequate seasonal lines of credit are essential for heating oil marketers to purchase their supplies, which must be paid for long before the customer pays for the oil. A reduction in lines of credit would threaten the ability of these marketers to finance their purchases, thereby jeopardizing their customers' well being, and the future of their businesses.

This decline in asset value, particular for small family owned enterprises, is harsh and unfair. It may also be unintentional because H.R. 4210 is not designed to produce major changes in taxable income; it is crafted to simplify the Code without generating major dislocations. Unless H.R. 4210 is modified, it will produce these significant inequities to petroleum marketers that have no basis in tax policy.

V. SUGGESTED MODIFICATION OF H.R. 4210

H.R. 4210 should be modified to lessen its negative impact on the heating oil industry and others similarly situated by allowing small covenants not to compete to be amortized over their actual contract term, rather than over 14 years. To prevent any possible abusive allocations of value to the covenant, and to limit the overall scope of the provision to small businesses, the provision would restrict the amount allocable to the covenant to no more than 40 percent of the value of the intangible assets transferred, with an absolute maximum of $2 million. In addition, the rule would apply only to transactions with total asset value under $10 million. These restrictions on the application of this rule guarantee that it could be used only by small businesses which have asset bases that are overwhelmingly intangibles. These are the businesses that are injured most sharply by the procrustean rule[4] proposed by H.R. 4210.

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[4] Procrustes, a mythical Attican lodgekeeper, applied the "one-size fits all" concept literally. He is best known for his peculiar means of ensuring a snug sleep for his guests. The generally accepted myth is that Procrustes (literally, "stretcher") maintained only one iron-framed bed in his lodge, which fit his own physique perfectly. He would invite travellers to spend the night in his care. Once they fell asleep, Procrustes would either use a rack to stretch the bodies of his shorter guests, or saw off the feet (and/or heads) of his taller guests, until they fit the bed

This change would have very little effect on Treasury revenues and no loss of clarity and simplicity. While many thousands of heating oil companies would suffer the unfairness of H.R. 4210 to their asset values and credit lines, Treasury revenues are directly affected only by those that sell out in a given year. That number is expected to continue in the annual range of approximately 25 to 50 companies, most from 1 to 5 million gallons, and some in the 5 to 10 million gallon range. In total, about 100 million "gallons" per year are sold.

The price currently paid for a retail home heating oil customer list varies by market and state but averages, currently, about $.40 per gallon of sales. Thus, the total value of annual transactions in the industry is about $40 to $50 million, of which some 75 to 80 percent represents the intangible assets. The total value of all intangible assets sold is approximately $32 to $40 million, of which under current law perhaps 10 to 20 percent or $4 to $8 million is goodwill, another 25 to 40 percent or $8 to $16 million is the covenant not to compete and the balance, or about $16 to $20 million represents the value of customer lists.

If one assumes that typically the covenant not to compete runs for 5 years and the customer list for 7 years, the annual intangible amortization from sell outs being taken under current law totals about $4 to $5 million.

By way of comparison, if a modification is made to H.R. 4210 that affords more economically realistic treatment, there would be no loss in revenues to the U.S. Treasury compared to current law. For example, if the heating oil industry were allowed to continue to amortize non-compete contracts in small transactions over their useful life of 5 years, up to a maximum of 40 percent of the value of the intangibles in the transaction, but in no event greater than $2 million, and customer lists and goodwill could be amortized over 14 years, the total annual amortization using such a formula would be approximately $3.9 to $4.9 million. Thus, such a change would be approximately revenue neutral to the Treasury.[5]

In contrast, if the 14 year amortization period now proposed in H.R. 4210 is made applicable to the heating oil industry, the amount of intangibles deducted annually would be about $2.3 million ($32 million divided by 14) to $2.8 million ($40 million divided by 14). Thus, H.R. 4210 would generate about $1.6 to $2.1 million more revenues from the heating oil industry than the modified proposal.

In short, a major problem in fairness for many thousands of small family-owned companies could be resolved with a de minimus change in Treasury revenue and no loss from current law. We believe that equity demands a simple modification such as this.

Prepared Statement of Robert S. Cooper

In the electronics industry that intellectual property is short-lived and must be constantly renewed. How this intellectual property is treated by U. S. tax law can have serious effects on our competitiveness and the way we conduct business. In particular, H.R. 4210, in extending the current depreciation schedule to fourteen years on high technology, is economically unrealistic. Technology does not last fourteen years.

We recognize that in many industries, a significant level of controversy exists between taxpayers and the I.R.S. over how to depreciate acquired intangible assets. And we do support the many efforts to bring increased certainty and simplicity to the tax code. After all, because we compete in an extremely volatile industry, we would appreciate a sense of stability in the tax code. Nevertheless, *we have some very serious concerns about the adverse impact this legislation would have on the ability of American companies to commercialize technology. Specifically, we are asking that the Committee amend the bill so as to: (1) exempt the purchase or license of high technology intellectual property from the fourteen-year depreciation schedule; and (2) provide a special rule that would apply to the acquisition of a small high technology company.*

In the fast-paced electronics industry, the value of technology evaporates rapidly. *Under current law, we typically depreciate technology in five years or less. By imposing a fourteen year depreciation schedule on technology, the Congress would increase*

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as well as he did. In either case, the guests would be dead by the time they "comfortably" fit in Procrustes' bed. Procrustes would then avail himself to all their gold.

[5] This is a "worst case" analysis, since it assumes that the maximum 40 percent will be allocated to the covenant in all cases. This will not occur, because some transactions will exceed $5 million (and the cap of $2 million will apply) and other transactions will allocate less than 40 percent to the covenant because of the seller's resistance to receiving this much of the sales price as ordinary income rather than as capital gains with a lower tax rate. Thus, the actual revenue impact will be more positive than this analysis suggests.

the write-off period by at least three times its current life. We estimate that such an extension will raise the after-tax cost of new technology by 12–20%. Because most of the technology acquisitions involve infant technology not yet brought to market, few electronics companies would benefit from the offsetting ability to amortize goodwill. *Hence, for all practical purposes, this legislation imposes a 12–20% "sales tax" on new technology when acquired by American companies.* A tax increase this big on an investment in capital—knowledge capital—is sure to handicap American companies in their efforts to compete globally.

THE INTANGIBLES LEGISLATION HINDERS THE AMERICAN ELECTRONICS INDUSTRY FROM COMMERCIALIZING TECHNOLOGY FASTER

In the electronics industry today, no priority is more important than reducing the time needed to transform new technology into a commercial product. In some industries, as their product lines mature, the rate of innovation slows and the lives of the products get extended. In our industry, just the opposite occurs. As we mature, the rate of innovation only increases. Indeed, the rate of change in the electronics industry continues to accelerate at a dizzying pace. Our product life-cycles are getting smaller and smaller with each new generation of products. Moreover, because American electronics companies seek to maintain worldwide leadership, we cannot be content to keep up with the rate of change in our industry; we must work to increase it. Consequently, we must reduce the time it takes to bring outstanding new products to market.

Yet, even as the pressure to speed up the development process continues to mount, technology has become more advanced and specialized. It has reached the point where even the largest, multi-billion dollar electronics companies cannot develop expertise in all of the technologies used in their products. And even if the expertise existed, no company can single-handedly afford the spiraling R&D costs and huge capital investments that are required to commercialize the new technologies on the shorter time-line.

Hence, AEA companies are becoming more specialized. We are focusing in-house R&D spending on our core competencies—those areas of technology where we have a strategic expertise. Then to access other key technologies, we coordinate with other companies. We form multi-company alliances, enter joint-ventures, cross-license technology, and purchase intellectual property. *In short, market conditions have forced our industry to develop a sophisticated, informal network for transferring and sharing technology among private companies.* We have had to abandon the "Lone Ranger" approach and share many key technologies with those we must fiercely compete with later. As David Nagel, the Senior Vice-President for Advanced Development at Apple Computer, Inc. has said in reference to Apple's highly visible collaboration with I.B.M., "We must have the courage to cooperate in the morning and the ability . . . to compete in the afternoon."

Many in Congress have been encouraging our industry to cooperate by sharing technology. *Yet, this legislation discourages many types of technology sharing by imposing a 12–20% tax on technology transactions such as licensing and outright purchases.* And since the cost of new technology is already high, this tax increase serves as a penalty for transferring technology to those who will invent and improve American products.

THE LEGISLATION PENALIZES TECHNOLOGY RISK-TAKING

A company is taking a substantial risk by investing in the purchase of infant technology because it may turn out to be unusable in their products. If so, an expensive asset can become immediately useless. As a point of fact, the failure rate of technology purchases is very high. When an acquisition goes sour, a company will normally sift through the technology for a few useful concepts and discard the rest. Under current law, we can dispose of the asset—or the useless portion of the asset—from our tax books immediately. But under the proposed rules in the intangibles legislation, the company is required to write-off the entire investment over fourteen years as long as any concept, however small, is salvageable. Hence, *a company would have to depreciate expensive technology over fourteen years even though 90% or more of the asset's value might have evaporated in the first or second year! As a result, this legislation increases the down-side risk of purchasing technology, thereby discouraging risky investments and experimentation with new technologies.*

THE INCIDENCE OF THE INCREASED TAX BURDEN WHICH ARISES FROM THIS LEGISLATION WILL FALL PRIMARILY ON AMERICAN COMPANIES

The extended depreciation schedule would apply only to technologies that are retained in the United States. If the title of the technology is transferred abroad, then

it will be subject to foreign amortization schedules (normally five years or less). Hence, *an American company seeking to buy American technology will face a 12–20% after-tax markup that a foreign company seeking the same technology is exempted from. Put differently, American technology is priced higher for American companies than for foreign companies.*

Many foreign companies have done an outstanding job of shopping for promising technology in the United States, commercializing it overseas, and exporting the resulting products all over the world. We do not begrudge foreign companies these successes. We believe in open technology markets, and are confident that we can compete in them. But *we do get concerned when American legislation would impose a sales tax on technology that is only collected from U.S. companies. Such a policy would encourage the exporting of American technology rather than the exporting of American products.*

THIS LEGISLATION IS ESPECIALLY PAINFUL FOR SMALL, NON-VERTICALLY INTEGRATED COMPANIES

Whine every company in our industry, from start-ups to major corporations, is having to become more focused and share technology with others, it is the smaller companies that are most adversely affected by this legislation. Large companies are more vertically integrated, and they have substantially larger R&D budgets. Hence, they are less inclined to purchase technology from other companies. In contrast, *small companies with only a few R&D engineers, a much smaller R&D budget, and a very focused R&D agenda are more inclined to license and purchase technology from other companies. Hence, the burden of the implicit technology sales tax will fall on small companies.*

When large companies do look for new technology, they have many more options than smaller companies in sharing technology, most of which are unaffected by this legislation. For example, it is principally the larger corporations who can afford to join the major technology alliances and consortia. The entrance costs are often prohibitively high for a small, under-capitalized technology company. Moreover, it is the larger companies who have enough R&D personnel to spin off a technology joint-venture. Small companies rarely have researchers that they can spare for jointly owned subsidiaries. In all of these options, large companies can avoid the adverse consequences of the intangibles legislation.

In contrast, smaller companies collaborate and grow together by licensing technology, purchasing technology rights, and buying other small companies. Yet, these transactions are all very negatively affected by the legislation. Hence, while large companies have many ways to share technology and avoid the longer depreciation life for technology, smaller companies have fewer options to avoid the fourteen-year life. *By virtue of having fewer options to share technology, it is the smaller, non-vertically integrated companies who suffer the most from the uniform depreciation schedule.*

THE LEGISLATION WOULD ALSO HURT THE ABILITY OF AMERICAN START-UP COMPANIES TO ATTRACT VENTURE CAPITAL

One factor given serious consideration by a venture capitalist is whether or not the start-up company seeking funding has a viable "exit strategy." If the company is unsuccessful in surviving independently, can the investment be salvaged by selling the company or its technology to an established company? Because of the after-tax markup and the difficulty in disposing of useless technology, this legislation will make the start-up a less attractive acquisition to buyers. In addition, the acquiring company might negotiate down the purchase price by 12–20% in order to force the incidence of the intangibles legislation upon the entrepreneur. So *whether a failed company cannot sell its technology, or whether it is forced to accent a lower selling price as a result of the intangibles legislation, venture capitalists will get a lower expected return on their investment. Consequently, they will be less inclined to risk investments in various companies.*

THE LEGISLATION WOULD RETARD AMERICAN EFFORTS TO DEVELOP NATIONAL CRITICAL TECHNOLOGIES

In recent years, much attention has been devoted to assessing the status of American efforts in developing critical technologies. The Report of the National Critical Technologies Panel, convened by the Office of Science and Technology Policy, was issued in 1989. The Department of Commerce issued a report, *Emerging Technologies: A Survey of Technical and Economic Opportunities* in 1990. The private sector Council on Competitiveness also issued the report, *Gaining New Ground: Technology Priorities for America's Future* in 1990. The Department of Defense is-

sued the Critical Technologies Plan in 1991. Most recently, the National Academy of Sciences issued its report, *The Government Role in Civilian Technology: Building a New Alliance,* in a Senate Commerce Committee hearing earlier this year. While these and many other reports do not agree on a comprehensive list of critical technologies or how to proceed on technology development, they do all indicate that technology development should be considered critical in this country. *Congress, for its part, has introduced many legislative proposals in an effort to spur technology growth in our country.* One such program at the Department of Commerce, the Advanced Technology Program, is already operational.

Yet, the intangibles legislation before you today would hinder the development of many critical technologies by making technology licensing and technology purchasing significantly more expensive and risky. The legislation will impact the development of technologies as diverse as semiconductor manufacturing equipment, advanced video displays, laser technology, high-definition imaging, computer systems technology, optoelectronics, space, satellite, and electronic navigational technologies. When one entrepreneur has advanced a critical technology as far as he can, public policy should encourage him to pass the baton to another who can advance the technology further. *It would be a serious mistake to inhibit the development of these and other future technologies in the United States by making the costs and risks of transferring technology significantly higher.*

The House of Representatives had the foresight to recognize that software technology must be treated differently from other intangible assets. We commend their vision. But today, *we are here to argue that a plethora of critical technologies—some not yet even imagined—also merit separate treatment from the fourteen year amortization schedule.*

EXAMPLES OF ACQUISITIONS OF HIGH TECHNOLOGY INTANGIBLE ASSETS

Trimble Navigation Limited is an example of one company in the aggressive U.S. GPS industry striving to maintain a competitive edge in rapidly expanding world markets. This world market opportunity was created by a $10–$12 billion American taxpayer investment. U.S. industry has an early lead, but the final outcome depends on a level worldwide playing field. To secure this lead, Trimble must supplement inhouse R&D, and extend its GPS technology with acquired or licensed application-specific technology.

The following examples illustrate the negative impact of this proposed fourteen year depreciation on both Trimble and its customers. Each example of a trade or business resulted in a new product. Under the H.R. 4210, both the acquisition and the resulting product would cost 12–20% more. This reduces Trimble's ability to bid competitively for critical technologies, and retards the customer's ability to risk increased investment in an emerging technology, like GPS.

In 1989, Trimble acquired GPS tracking system engineering know-how from TAU Corporation. Trimble then developed a GPS-based vessel-tracking and monitoring system. This product adds another level of safety in preventing disastrous oil spills, such as the Exon-Valdes. U.S. commercial shipping is already investing in these systems to improve safety and to increase fleet operating efficiency. Because of already tight profit margins, H.R. 4210 could result in slowing their investment in these systems.

This GPS tracking know-how is also critical to the public and the Federal Aviation Administration (FAA) in improving airport safety. GPS tracking technology will help prevent airplane and vehicle collisions on airport runways similar to the recent Los Angeles airport disaster. H.R. 4210, could not only impede Trimble's ability to produce innovative products for these new safety applications, it could also slow the American public's ability to use their own national resource technology.

Successfuly outbidding a foreign competitor, Trimble bought the intellectual property of a company called Avion to enter the aviation collision avoidance business, This emerging GPS market expands the U.S. civil aviation business.

The aviation use of GPS technology is potentially very valuable in public disasters like the recent Oakland/Berkeley fire. Aircraft dropping fire-retardant were grounded at night for pilot safety. With GPS-based avionics, pilots could have dropped chemical retardant in the dark and made more accurate daylight drops without endangering ground-based fire-fighters. Unfortunately, a house burned every 11 seconds until the fire was controlled. Using GPS aviation technology, could have helped to contain this tragedy sooner.

CONCLUSION

The legislation to reform the amortization of intangible assets has admiral objectives. But AEA is extremely concerned about its impact on our ability to develop

American technology at an increasingly rapid pace. The legislation discourages technology risk-taking by making it difficult to abandon useless technology. The incidence of the new tax burden from a longer amortization schedule would be borne chiefly by American companies and would disproportionately hurt small, non-vertically integrated companies. It would make start-up companies a relatively less attractive venture capital investment, and it would hinder the nations's overall effort to develop many national critical technologies. *In short, this legislation has very negative technology policy ramifications.*

For two hundred years our economy has been fueled by the manufacture and exchange of tangible commodities. But in the last quarter of this century, an information revolution has changed the economic landscape. Adapting a now familiar phrase, *our nations faces a "new economic order."* Strategic, national resources now include more than just natural resources such as land, minerals, and fossil fuels; they include intangible assets such as ideas and technology. *We are moving increasingly from material-based to knowledge-based production.* By way of example, management visionary Peter Drucker estimates that between 1965 and 1985. Japan increased industrial production two and a half times, and yet its consumption of raw material and energy barely went up at all. How can this happen? Japan's manufacturing inputs are knowledge-intensive, not material-intensive. *We are reaching the point where the manufacture and sale of ideas is becoming at least as important as the manufacture and sale of durable goods.* In light of these new economic realities, we must work now to cultivate these knowledge-based strategic resources so that our country is resource-rich in the information age. *Our nation cannot afford to slow the construction of our national technology base by imposing a sales tax on new ideas—critical factors of production—and increasing the risks associated with technology sharing.*

The AEA's proposed changes to the intangibles legislation will be submitted in a separate appendix to this testimony at a later date. We realize that our proposed amendments to the intangibles legislation make the legislation mildly less simple. But *we believe that a little less simplicity in exchange for the continued ability to make capital investments in technology without increased costs and risks is a good trade-off.* We are confident that with a sound public policy environment that recognizes the importance of new technology, our industry can continue to offer world class jobs and export world class products.

Thank you, Mr. Chairman.

Attachments.

AMERICAN ELECTRONICS ASSOCIATION—RECOMMENDED REVISIONS TO PROPOSED SECTION 197

REVISION TO PROPOSED SECTION 197(e) TO EXCLUDE CERTAIN HIGH TECHNOLOGY INTANGIBLE PROPERTY FROM H.R. 4210, SUBTITLE E., SEC. 4501. (SUBSTANTIVE CHANGES IN ITALIC)

(e) EXCEPTIONS:

(7) *CERTAIN HIGH TECHNOLOGY INTANGIBLE PROPERTY.*—The term "section 197 intangible" shall not include any—

(A) high technology intangible property acquired from a person that regularly licenses, rents, or sells high technology-based products in the ordinary course of business to customers, provided that the acquired property is not, except as provided in subparagraph (e)(8), licensed or purchased in a transaction directly or indirectly related to the acquisition of the assets constituting an entire trade or business.

Note: The exception for computer software contained in proposed section 197(e)(3) of H.R. 4210 would be modified as appropriate to take into account the computer software provisions of proposed section 197(e)(7).

(8) CERTAIN HIGH TECHNOLOGY TRADE OR BUSINESS ACQUISITIONS—notwithstanding the provisions of subparagraph (e)(7)(A), the term "section 197 intangible" shall not include high technology intangible property acquired in connection with the acquisition of a high technology trade or business—

(A) if the value of the high technology intangible property acquired as an integral part of the acquired high technology trade or business represents a substantial portion of the total value of the consideration paid to acquire the intangible assets which are included in the acquisition of the high technology trade or business, and

(B) the total value of the consideration paid to acquire the high technology trade or business does not exceed $50,000,000, such value to be adjusted for inflation under such rules as the Secretary may prescribe.

(Please refer to accompanying proposed Committee Report language.)

AMERICAN ELECTRONICS ASSOCIATION—RECOMMENDED REVISIONS TO PROPOSED SECTION 197

COMMITTEE REPORT LANGUAGE TO ACCOMPANY REVISION TO PROPOSED SECTION 197(e) TO EXCLUDE CERTAIN HIGH TECHNOLOGY INTANGIBLE PROPERTY FROM H.R. 4210, SUBTITLE E., SEC. 4501

1. For purposes of proposed section 197(e)(7)(A):

(a) Rationale for exclusion of high technology intangible property—The Committee has excluded the license or purchase of high technology intangible property from the scope of section 197, provided that it is unrelated, except for the trade or business exception provided in proposed section 197(e)(8), to the acquisition of the assets comprising an entire trade or business, because it believes that:

(i) if a vendor (including both a licensor and seller) regularly licenses or sells high technology-based products to customers in the ordinary course of its trade or business and the particular high technology intangible property acquisition is not related to the purchase of an entire trade or business, the acquisition from such a vendor does not raise significant valuation and identification issues that, in part, have prompted the Committee to favorably report H.R. 4210, and

(ii) since the current life cycle for high technology intangible property is generally less than five years and rapidly declining, the acquisition of high technology intangible property does not raise the significant amortization period issues that also have caused the Committee to favorably report H.R. 4210.

(b) Definition of "high technology intangible property"—section 4501 of H.R. 4210 is legislation intended to clarify the tax treatment of intangible assets acquired either through trade or business acquisitions or stand-alone transactions. Generally, the legislation incorporates the provisions of H.R. 3035, which was introduced by Ways and Means Committee Chairman Dan Rostenkowski (D–IL) last year, and would require acquired intangible assets, including goodwill and going concern value, to be amortized over 14 years.

Significantly, the Congress made revisions to the original bill. Most notably, many types of acquisitions, including certain software, motion pictures, video tapes, books and similar intangibles, were excluded from the types of acquisitions subject to 14-year amortization.

Noticeably absent from this exclusion, however, were high technology intangible assets. Such assets include technology developed in the areas of the physical sciences, mathematics, engineering, and electronics. It includes technology related to hardware, firmware (embedded code), software, know-how, secret processes, and other technical engineering, algorithmic or scientific principles, including, but not limited to patented, copyrighted, and unpatented technology as identified by Rev. Procs. 69–19 and 69–21, and Rev. Rul. 64–56. Such property excludes goodwill and going concern value, represents a discovery which is original, unique and novel to the developer, and is protected by the trade secret laws of the United States and any state or instrumentality thereof. High technology intangible assets are formulated by the process of research and experimentation and are short lived, as is the case with software and films.

Without change, this treatment of transfers of high technology intangibles does not further the goal of tax simplification and would substantially increase the after-tax cost of acquiring high technology intangibles.

It has been argued that high technology intangible assets are difficult to define and for this reason, they have not been excluded. Computer software should continue to be defined by Rev. Proc. 69–21. One of the following four alternative approaches could be used to define other high technology intangibles:

(i) *know-how and intellectual property*—the term "section 197 intangible" would not include any formula, process, design, pattern, know-how, format, trade secret, or other similar item that is not acquired, except as provided in proposed section 197(e)(8), in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business.

(ii) *know-how developed through research and experimentation*—the term "section 197 intangible" would not include any formula, process, design, pattern, know-how, format, trade secret, or other similar item if:

(A) a substantial portion of the value of such formula, etc. is attributable to research or experimental expenditures paid or incurred within the five year period immediately preceding the transaction, and

(B) it is not acquired, except as provided in proposed section 197(e)(8), in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business.

(iii) *high technology know-how*—the term "section 197 intangible" would not include any "high technology intangible asset" that is not acquired, except as provided in proposed section 197(e)(8), in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business.

The Treasury Department would be authorized to issue regulations that provide guidance as to what types of intangible assets constitute "high technology intangible assets." Congress intends and expects that these regulations will provide that the term "high technology intangible asset" shall include technology that relies on the principles of the computer or the physical sciences, mathematics, engineering, or electronics that is formulated by the process of research and experimentation, and computer software. Congress intends that these regulations are to apply as of the effective date of the new section 197.

(iv) *electronics high technology know-how*—the term "section 197 intangible" would not include any "high technology intangible asset" that is not acquired, except as provided in proposed section 197(e)(8), in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business.

The Treasury Department would be authorized to issue regulations that provide guidance as to what types of intangible assets constitute "high technology intangible assets." Congress intends and expects that these regulations will provide that the term "high technology intangible asset" would include, inter alia, technologies developed for incorporation into or use in either the development of or manufacturing of property within the following 2-digit Major Groups of Standard Industrial Classification code set forth in Executive Office of the President, Office of Management and Budget, *Standard Industrial Classification Manual (1987)*: Major Groups 35, 36, 37, and 38. Computer software would also be a "high technology intangible asset." Congress intends that these regulations are to apply as of the effective date of the new section 197.

The Committee recognizes that as technology advances, the definitions of "technology derived from the physical sciences, mathematics, engineering, and electronics" also will expand and will tend to become more specific. For example, a contemporary enumeration of this technology would include, in addition to the technology existing when Rev. Proc. 69–19 and Rev. Rul. 64–56 were issued, circuit board designs, product designs of semi-conductors, space and satellite technology systems, biotechnology, advanced video display technology, optoelectronics, superconductivity, applications specific integrated circuits (ASIC), electronic navigation equipment, sound technology for computers, high density television (HDTV), and X-ray lithography, although Rev. Proc. 69–19 and Rev. Rul. 64–56 in their current form are broad enough to encompass these items. Therefore, the Committee desires to maintain the present law flexibility that will enable the definitions of "technology derived from the physical sciences, mathematics, engineering, and electronics" to evolve as technology advances.

(v) Definition of "computer software"—except as otherwise stated below, the term "computer software" shall have the same meaning as it does in Rev. Proc. 69–21, supra. Further, as in Rev. Proc. 69–21, "computer software" shall include "computer programs," which programs may be expressed in either object or source code. The Committee recognizes that as technology advances, the definitions of "computer software" and "computer programs" also will expand and will tend to become more specific. For example, a contemporary enumeration of "computer programs" would include, in addition to the items specifically mentioned in Rev. Proc. 69–21, systems integration software, network software, interactive programs and the digitalized text, graphics, sounds, and images that are capable of being included as part of the systems or programs enumerated in the revenue procedure, although Rev. Proc. 69–21 in its current form is broad enough to

encompass these items. Therefore, the Committee desires to maintain the present law flexibility that will enable the definitions of "computer software" and "computer programs" to evolve as technology advances.

[Note: Sec. 2 of Rev. Proc. 69–21 states that "computer software" includes all programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs. The Rev. Proc. defines "computer programs" as including operating systems, executive systems, monitors, compilers and translators, assembly routines, utility programs and application programs. The above discussion is intended to increase the specificity of the definitions contained in Rev. Proc. 69–21 as follows:

"Computer software" encompasses all programs or routines,whether expressed in object or source code, used to cause a computer to perform a desired task or set of tasks, the documentation required to describe and maintain those programs,and the algorithims, architecture, copyrights, patents, trademarks, trade-secrets, and know-how related thereto. Computer programs of all classes, for example, operating systems, executive systems, systems integration software, network software, monitors, compilers and translators, assembly routines, utility programs, applications programs and interactive programs and digitalized text, graphics, sounds and images that can be included as part of such systems and programs are included. "Computer software" does not include procedures which are external to computer operations, such as instructions to transcription operators and external control procedures.]

(c) The Committee intends that the determination whether a person "regularly licenses or sells high technology-based products to customers in the ordinary course of business" to be based on all the facts and circumstances. However, the Committee wishes to make clear that the vendor need not have previously licensed or sold products based on the high technology intangible property in question as long as it regularly licenses or sells other high technology-based products to customers in the ordinary course of its trade or business. Thus, high technology intangible property that is newly created or newly modified, or is one-of-a-kind technology that has been custom designed for a particular user, will be excluded from section 197 if the licensor or seller regularly licenses or sells other types of high technology-based products to customers in the ordinary course of its trade or business. Similarly, a new vendor, which has not previously licensed or sold high technology-based products, nevertheless will satisfy the "regular license or sale" test if it expects to actively engage in the regular license or sale of high technology-based products to customers in the ordinary course of a trade or business.

It also is not necessary that the licensing or sale of high technology-based products constitute the vendor's sole or principle business activity, provided that licenses or sales to customers occur, or are expected to occur, in sufficient volume and with sufficient frequency to indicate that the transactions are not isolated or one-of-a-kind. For example, the licensing or sublicensing of a computerized reservations system by an airline to travel agents within the airline's service area would constitute the regular license of computer software. Likewise, the sale of computer software by a leasing company incident to the sale of computer hardware following the expiration of a hardware lease and software license would constitute the regular sale of computer software if the leasing company is able to establish that such practice is a normal, repetitive part its trade or business. On the other hand, the acquisition of a computer program from a seller that does not regularly license or sell high technology-based products to customers in the ordinary course of its trade or business but merely is seeking to dispose of software that is no longer useful in its business would be excluded from section 197.

(d) In applying the exclusion contained in proposed section 197(e)(7)(A), it is irrelevant whether the vendor created the high technology intangible property itself, licensed or purchased the high technology intangible property from another person, or modified licensed or purchased high technology intangible property for to sublicense or resale.

2. For purposes of proposed section 197(e)(8):

(a) Rationale for the exclusion of high technology intangible property acquired in certain high technology trade or business acquisitions—The committee has excluded the purchase of high technology intangible property acquired in the acquisition of certain high technology trade or business because it believes that:

(i) the value of small high technology trade or businesses consists primarily of high technology intangible property, these trade or businesses do not possess significant goodwill or going concern value, and the acquisition of high technology intangible property by acquiring these trade or businesses does not raise significant valuation and identification issues that, in part, have prompted the Committee to favorably report H.R. 4210. The Committee intends to limit this exception to the acquired high technology intangible property; section 197 intangibles acquired in connection with the acquisition of a high technology trade or business would remain subject to the amortization provisions of proposed section 197(a).

(b) Definition of "high technology trade or business"—the term "high technology trade or business" shall, for purposes of the exclusion, be defined to include any trade or business that, as its principle business activity, regularly licenses or sells high technology-based products to customers in the ordinary course of its trade or business. The Committee intends that the determination whether a person "regularly licenses or sells high technology-based products to customers in the ordinary course of its trade or business" to be based on all the facts and circumstances. However, the Committee wishes to make clear that a new trade or business, which has not previously licensed or sold high technology-based products, nevertheless will satisfy the "regular license or sale" test if it can establish that it expects to actively engage in the regular license or sale of high technology-based products to customers in the ordinary course of a its trade or business.

(c) For purposes of the requirement of proposed section 197(e)(8) that the high technology intangible property acquired represent a "substantial" portion of the total value of the acquired high technology trade or business, the value of the high technology intangible property acquired should be equal to at least 75% of the total value of all of the intangible property acquired in the acquisition of the high technology trade or business. The value of the high technology intangible property acquired is to be determined based upon all the facts and circumstances and agreed upon by the parties to the transaction. Factors to be considered include but are not limited to, the existence of an independent appraisal report, the nature of the pre-acquisition research and development spending of the acquired trade or business, and the pre-acquisition revenues generated by the high technology-based products sold by the acquired trade or business which incorporate the high technology property being valued. For purposes of this valuation measurement, the Committee intends that the high technology intangible property be considered to include prior versions and all high technology intangible property within the same high technology intangible property category.

The high technology intangible property categories to be used for this purpose are enumerated in the Committee's definition of high technology intangible property.

(d) Clarification of the dollar limitation to the high technology trade or business exclusion contained in proposed section 197(e)(8)(B)—The Committee intends that the dollar value limitation on the exclusion for certain high technology intangible property acquired in the acquisition of a high technology trade or business function to limit the potential for significant valuation and identification issues that, in part, have prompted the Committee to favorably report H.R. 4210. The Committee believes that the value of small high technology trades or businesses consists primarily of high technology intangible property, and that these trade or businesses do not possess significant goodwill or going concern value. Therefore, the Committee expects that high technology trade or businesses which satisfy the dollar-value limitation test of proposed section 197(e)(8)(B), and can provide reasonable evidence that they satisfy the "substantial" value test of proposed section 197(e)(8)(A), should, in the absence of substantial evidence to the contrary, qualify for the exclusion provided by proposed section 197(e)(8).

The Committee intends that the Secretary prescribe regulations to provide for adjusting the dollar-value limitation provided by proposed section 97(e)(8)(B) for inflation. The Committee expects that the adjustment will be based upon a generally accepted measure of inflation for trade or businesses, such as the Producer Price Index.

PREPARED STATEMENT OF PETER L. FABER

Mr. Chairman and members of the Committee: My name is Peter L. Faber. I am the Chair of the American Bar Association's Section of Taxation. With me is David G. Glickman, Chair of the Section's Task Force on Intangibles. I am testifying today on behalf of the American Bar Association at the request of Talbot S. D'Alemberte, President of the Association, to discuss simplifying the tax treatment of intangible assets acquired in business purchases and the portions of H.R. 4210, the Tax Fairness and Economic Growth Act of 1992, related thereto (the provisions of H.R. 4210 relating to the amortization of intangibles are hereinafter referred to as the "Bill").

GENERAL COMMENTS

We are pleased to have this opportunity to testify at these hearings on simplifying the amortization of intangibles. We also appreciate the deliberate open hearing process through which this issue is being considered. The Association believes that, through the open process of these public hearings, legislation may be carefully and deliberately considered, thereby resulting in superior legislation.

As we have testified in the past before this Committee, the Association unequivocally supports simplification of the tax law. Simplification generally increases respect for the tax system, enhances compliance, and leads to a more consistent and predictable application of the tax law. By reducing uncertainty, simplification reduces the number of controversies between taxpayers and the Internal Revenue Service (the "Service") and the costs for both taxpayers and the government associated with resolving such controversies. This increase in predictability and decrease in controversy produces a more efficient tax system, but it may also require a tradeoff with respect to other laudable tax policy goals, such as accurate measurement of net income, equity, and fairness. Congress must strike a balance among these desirable tax policy goals.

The amortization of intangibles is an area of the tax law that particularly requires legislative change. Although simplicity in taxation may be difficult to define, it is clear that the current state of law in regard to amortization of intangibles is uncertain and complex under any definition. The amortizability of many intangible assets is unclear and allocation questions are present in virtually all acquisitions of businesses, as virtually all existing trades or businesses possess intangible assets (such as goodwill or going concern value). The depreciation rules for tangible assets have been revised numerous times in the past eleven years, but the amortization of intangible assets generally has not been addressed in recent legislation.[1]

Treasury regulations have historically provided that goodwill is nonamortizable. Other intangible assets, however, can be amortized, if the taxpayer can demonstrate that the asset has an ascertainable value separate from goodwill and a limited and determinable useful life. In the context of the acquisition of the assets of a business, taxpayers often clash with the Service over (1) whether a particular intangible asset is distinguishable from goodwill; (2) whether the asset has a limited and determinable useful life; and (3) the value of the asset. Because of the lack of statutory, regulatory or other guidance in this area, taxpayers and the Service each are often forced to present detailed statistical and factual evidence and reports or testimony in a "battle of the valuation experts."

The problem of distinguishing between nonamortizable goodwill and amortizable intangibles can be illustrated by the acquisition of a business in which the seller also enters into a covenant not to compete. It is a well-established principle of law that the value paid to a seller of a business for a covenant not to compete with the buyer is amortizable over the period of the covenant. While this sounds like a simple concept, in practice the valuation of a covenant not to compete is particularly troublesome. It is often hard to distinguish between and separately value goodwill and a covenant not to compete. The Service can attempt to protect the fisc in this situation, but there are no real guidelines for the Service to use in determining the value of the covenant not to compete and, as numerous cases show, the valuation of goodwill is always a difficult matter.

The magnitude of current taxpayer disputes with the Service over the amortization of intangible assets is documented in a recent General Accounting Office report ("GAO Report").[2] The GAO Report found that as of 1989 there were 2,166 open cases in the Service's examinations, appeals, and litigation units involving the amor-

[1] In 1989, the amortization of principal sum payments for franchise acquisitions under Section 1253 was lengthened from 10 years to 25 years where the franchise has a value in excess of $100,000.

[2] *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets* (GAO/GGD-91-88, released 8/12/91).

tization of intangibles. The Service had proposed adjustments of over $8 billion in these cases. In 70% of these cases, the Service challenged taxpayers primarily on the classification of assets as intangible assets other than goodwill. In the other 30%, the Service challenged taxpayers' determinations of value and/or useful life.

The Supreme Court of the United States has recently granted a writ of certiorari in a case involving the amortization of intangibles, *Newark Morning Ledger Co.* v. *United States*, 945 F.2d 555 (3d Cir. 1991). In this case the government contends that the taxpayer cannot amortize purchased customer lists, for which it has established both value and useful life, because it has not established that the value of the lists is separate and distinct from goodwill. Although the Court's decision in this case may clarify some of the legal issues regarding the amortization of intangibles, that decision is unlikely to reduce substantially existing and future factual controversies between taxpayers and the Service regarding the amortization of intangibles. We believe that meaningful simplification is not achievable without legislation.

The Association applauds Chairman Bentsen, other Committee members and the Committee staff for their desire and efforts to simplify the tax laws. It will never be possible to eliminate all controversies between taxpayers and the Service over the amortization of intangibles, but the legislative approach embodied in the Bill would represent a major step forward. Thus, the Association strongly supports the Bill.

In today's statement, I will address some of the broader policy issues implicated by the Bill. A detailed technical analysis of the Bill will be submitted to the Committee and its staff in the near future.

SINGLE AMORTIZATION PERIOD

The Association strongly supports the Bill's use of one amortization period for all intangible assets. The Association recognizes that a certain amount of distortion is inevitable under a single recovery period system, but it believes that such distortion is preferable to the potential classification disputes that would arise if different classes of intangibles could be amortized over different periods.

At the same time, without holding up the legislation, we suggest that the Bill request the Treasury to study whether the useful lives of intangible assets vary significantly across different industries or among different categories of intangible assets. If significant variances do exist, consideration should be given—to whether different amortization periods should be prescribed for different industries or different intangible assets.

SCOPE

The Bill generally applies to all acquisitions of intangible assets irrespective of whether they are acquired in connection with the acquisition of a business. There are exceptions, however, for enumerated intangible assets that are not acquired as part of the acquisition of a trade or business. For example, the following types of property, if acquired in the ordinary course of business, would not be "Section 197 intangibles" and thus would not be subject to 14-year amortization: covenants not to compete; patents; copyrights; computer software; interests in films, sound recordings, video tapes, books, or similar property; and rights to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof. In addition, there are other exceptions to the 14-year amortization rule for certain other intangible assets, even if acquired as part of the acquisition of a trade or business (such as certain computer software which is readily available to the general public and franchises to engage in professional sports).[3] Thus, the Association notes that the Bill does not reflect a consistent choice between covering (i) all acquisitions of intangible assets (the "all inclusive" approach), or (ii) only those acquisitions of intangible assets that are a part of the acquisition of a trade or business (the "narrow approach").

The all-inclusive approach generally solves all three areas of controversy—separation of goodwill and going concern value from amortizable intangibles, limited life, and allocation of value—and thus promotes more transactional neutrality. Similar rules would apply to all taxpayers who acquire similar intangible assets, regardless of whether the intangible acquisition was part of the purchase of a trade or busi-

[3] The legislative history of the Bill does not explain, nor are we aware of any tax policy reason why the acquisition of professional sports franchises and items acquired in connection therewith should be treated differently than other intangible assets. Section 1056 provides limitations on the allocation of a portion of the purchase price of a professional sports franchise to player contracts. If Section 1056 continues to apply to professional sports franchises and section 197 is inapplicable, all three areas of controversy—separation of goodwill and going concern value from amortizable intangibles, limited life, and allocation of value—will continue to exist in the context of acquisitions of professional sports franchises.

ness. Thus, this approach would avoid the potential that would exist for bifurcating acquisitions if the Bill applied only to intangible assets acquired as part of the purchase of a trade or business.[4]

On the negative side, the all-inclusive approach may not accurately reflect net income. Requiring 14-year amortization of demonstrably shorter-lived assets or demonstrably longer-lived assets may significantly distort net income for various taxpayers[5] and may not reflect accurately the true economic depreciation of the acquired assets.

The narrow approach also has its advantages and disadvantages. It targets the main area for which simplification is needed—acquisitions of trades or businesses. Thus, it will limit the three main areas of controversy involving intangibles—separation of goodwill and going concern value from amortizable intangibles, limited life, and allocation of value among assets. Yet the narrow approach does not create the distortions that would result when discrete assets with relatively easy-to-determine limited lives are acquired. Narrowing the Bill to avoid such distortions need not violate the Bill's simplification goal; the principal controversies that the Bill seeks to minimize, distinguishing between goodwill/going concern value and amortizable intangibles, arise only in the context of the purchase of a trade or business. In fact, the stated purpose of this hearing is to consider the tax treatment of intangibles acquired in business purchases.

However, the narrow approach can result in disparate treatment of taxpayers depending upon whether or not they acquire a particular type of intangible asset as a part of the acquisition of a trade or business. In addition, one of the simplicity advantages of the all-inclusive approach, avoiding the determination of when a trade or business is acquired and, therefore, when the Bill applies, is lost under the narrow approach. We appreciate the difficulty of this issue. We note, however, that the concept of acquisitions of trades or businesses being treated differently from discrete asset purchases is already present in the law in Section 1060, dealing with the allocation of value among assets and the required reporting of same, is present in numerous other statutory provisions, and is also reflected in a number of places in the Bill. Concerns regarding abuses of the narrow approach might be ameliorated by directing the Treasury to exercise its authority to promulgate regulations regarding the issue.

To sum up, while the all-inclusive approach may be the most simple and result in the most transactional neutrality, the narrow approach accomplishes simplicity where it is most needed and may result in less distortion in the measurement of net income. It is therefore recommended that the provisions regarding the amortization of intangibles be applied only to intangibles acquired as part of the acquisition of a trade or business.

ASSET-BY-ASSET APPROACH

The Bill's rules on dispositions require an asset-by-asset tax accounting approach. In general, the Bill disallows the recognition of losses (the unrecognized loss is added to the basis of the remaining intangible assets) but requires the recognition of gain upon the disposition of an intangible. To calculate gain and loss on an asset-by-asset basis, taxpayers will have to keep track of the basis of each of their intangible assets. Any portion of the purchase price in any acquisition attributable to intangible assets will have to be allocated among those assets. Because some intangible assets are more likely to be sold than other intangible assets, taxpayers will have an incentive to attempt to manipulate the purchase price allocation. The Bill's asset-by-asset approach effectively reintroduces the very classification, valuation, and duration issues that the Bill seeks to eliminate.

The Association recommends that the Bill adopt a unitary asset approach applicable to each separate acquisition.[6] Under this approach, all intangibles acquired in a single transaction would be treated as one asset with one unitary basis. There

[4] For example, if the narrow approach were adopted and there existed sufficient economic advantage (considering transaction costs and the like), in connection with the acquisition of the assets of a trade or business a taxpayer could exclude selected fungible intangible assets and then separately purchase them from a third party to avoid 14-year amortization. Likewise, a taxpayer could attempt to separate a purchase of intangibles from a purchase of the rest of the assets of a trade or business from the same seller. We believe, however, that the first situation should not be considered a serious problem and that the second situation can be dealt with by rules aggregating the seemingly separate purchases.

[5] It should be noted that the distortions may balance out where assets are acquired in the context of an acquisition of a trade or business, since the lengthening of shorter-lived assets may be offset by the shortening of longer-lived assets.

[6] Other alternatives may be to treat all acquisitions of intangibles in each year as a unitary asset, or to treat all acquisitions of intangibles regardless of the year as a unitary asset.

would be no need to keep track of the basis of any particular intangible asset acquired in that acquisition, drastically reducing the classification, valuation, and duration disputes that exist under current law. Additional purchases that enhance the original intangible would increase the unitary basis. Dispositions could be handled in one of three ways.[7]

First, no gain or loss could be recognized on the disposition of an intangible. Instead, the unitary basis would be reduced (but not below zero) by the amount of the proceeds. To the extent that the proceeds exceed the aggregate basis, the taxpayer would recognize the excess as income. This basis recovery method favors taxpayers.

Second, the taxpayer could include the full amount of the proceeds in its income. The taxpayer would continue amortizing the unitary basis over the 14-year period specified in the Bill. This method favors the fisc.

Third, the taxpayer could include in income that portion of the proceeds equal to the amortization it had previously deducted. The balance of the proceeds would reduce unitary basis. The taxpayer would recognize income to the extent the balance of the proceeds exceeded the unitary basis. This method is a blend of the first two methods.

REVENUE IMPACT

We note that your Committee is constrained to report out only revenue neutral legislation. It is the Association's position that, to the extent that necessary modifications to the legislation to balance desirable tax policy goals result in revenue losses, such revenue losses should be made up by such additional modifications of the legislation as do the least harm to achieving the optimal balance of those goals. Likewise, the Association believes that simplification legislation in this area should not be used as a revenue raiser to spend on other revenue losing provisions.

RETROACTIVITY

Retroactivity and effective dates for tax legislation are complex issues. The Association's general stance is that retroactive laws are appropriate only in limited circumstances. H.R. 4210 contains a novel approach to retroactivity, providing retroactive application of the new rules (with a longer amortization period) at the taxpayer's election under certain circumstances. Although we are favorably inclined to the idea of eliminating costly litigation for both the government and the taxpayer over issues essentially resolved in the Bill, we have reservations about the particular approach adopted.

Is it wise to create a precedent for permitting either the government or the taxpayer to have the option to choose which set tax laws will be applied to transactions years after they have occurred? How can we make sure that taxpayers whose cases have already been resolved are fairly treated by comparison with those whose cases are still in controversy And what should be done about taxpayers whose cases were never in controversy, or those who made irrevocable decisions to proceed on the basis of the old law as they understood it? These are all difficult questions made more difficult by the revenue implications of the elective retroactive application of the Bill.

The Association can, however, endorse as a simplification measure the concept of directing the Service to expedite the settlement of pending cases in a manner that takes into account the principles of the Bill. Balancing the competing administrative, policy, and revenue objectives is a difficult, but necessary, task for the Congress in this complicated area.

Finally, when legislation of this significance is pending before Congress for one or more years prior to adoption, substantial questions of reliance and fairness exist with regard to transactions negotiated after introduction but before enactment of the legislation. When the Bill is finally enacted, we would encourage consideration of fair transition relief for such transactions.

EFFECT ON COMPETITIVENESS

There has been some discussion that most of the major trading partners of the United States, with the exception of France and the United Kingdom, permit some form of amortization of goodwill for tax purposes and, therefore, derive a competitive advantage. The Association notes that, with respect to this issue, there are many differences between each country's tax laws, including rates, and any comparison to

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[7] The Association would be happy to prepare a more detailed memorandum explaining these methods.

other countries' tax systems in regard to the amortization of goodwill must take into account all of these differences. Moreover, we note that foreign corporations doing business in the United States are generally treated the same as domestic corporations doing business in the United States in regard to the amortization of goodwill.

In summary, the Association congratulates the Chairman of the Committee, the other Committee members and the Committee staff for their support for tax simplification legislation. We also appreciate the deliberate open hearing process through which this simplification legislation is being considered. We look forward to working with the Committee and its staff in refining this legislation, which we strongly believe deserves to be enacted.

I would be happy to respond to your questions. As I stated earlier, the Association is in the process of preparing more detailed technical comments on these Bills and will forward them to Committeo add its staff as soon as they are completed.

PREPARED STATEMENT OF FRED T. GOLDBERG, JR.

Mr. Chairman and Members of the Committee: I am pleased today to present the views of the Administration on proposals to amend the tax laws to provide certainty concerning the tax treatment of purchased intangible assets. I am accompanied by Hap Shashy, the Chief Counsel of the Internal Revenue Service.

Last October, Hap and I, together with my predecessor, Ken Gideon, provided Administration testimony in support of H.R. 3035, a measure introduced by Chairman Rostenkowski to simplify the tax treatment of intangibles. A modified version of H.R. 3035 was included in H.R. 4210, as adopted by the Congress. My statement today will focus on the differences between those two bills. A more extended discussion of the Administration's views on the importance and parameters of intangibles legislation is contained in our prior testimonies, copies of which are being provided for the record.

Before turning to the specific differences between H.R. 3035 and H.R. 4210, I would like to offer a number of general observations.

Having seen the tax system from a number of perspectives—as a practitioner, as Chief Counsel and Commissioner of the Internal Revenue Service, and now as Assistant Secretary for Tax Policy—I regard the legislation concerning intangibles as the most important simplification measure under consideration by the Congress. The current regime for taxing purchased intangibles:

- results in substantial uncertainty and the unequal treatment of similarly situated taxpayers;
- imposes needless transaction and administrative costs on taxpayers and the Government;
- leads to frequent and expensive controversies between taxpayers and the Internal Revenue Service; and
- deprives the Federal Government of substantial tax revenues that are properly due and owing.

No amount of after-the-fact enforcement and litigation can remedy the situation—legislation is essential if we are to eliminate this source of waste, inefficiency, and controversy.

I also want to emphasize my belief that the stakes go far beyond the issue at hand. The legislation you are considering is the product of more than 18 months of cooperation among the Congress, the Administration, and the private sector. In many respects, it is the centerpiece of our simplification efforts. It is not perfect—but there is no such thing as the perfect law. It is fair and reasonable; it achieves its stated objectives and is consistent with fundamental principles of sound tax policy; and it is a dramatic improvement over the current state of affairs. I believe it is the litmus test of our commitment and ability to achieve broad-based simplification of substantive tax laws. If legislation along the lines you are considering cannot be enacted, I see little hope for our ability to simplify elsewhere.

Finally, I want to reiterate two principles that have shaped H.R. 3035 and H.R. 4210. First, to avoid lengthening the recovery period and reduce to a minimum the complexity of allocating purchase price among intangible assets, we must strictly limit the classes of intangibles that are excluded from 14-year amortization. Second, the legislation must be essentially revenue neutral.

The remainder of my testimony provides the Administration's views on the primary changes to H.R. 3035, as reflected in H.R. 4210: (1) the modified or clarified treatment of computer software, mortgage servicing contracts, movies, and government-granted rights and licenses; and (2) provisions authorizing taxpayers to elect retroactive application of the statute. In brief, we believe that the former changes

are appropriate—they are minor modifications, largely clarifying in nature and consistent with the intent and structure of the original legislation. In contrast, certain aspects of elective retroactivity raise significant revenue and policy concerns.

ADMINISTRATION'S POSITION

Software. H.R. 3035 provided a 14-year amortization period for computer software regardless of whether it was purchased on a stand-alone basis or in connection with the acquisition of a trade or business. In our testimony before the Committee on Ways and Means, we expressed the view that the proposed legislation should not cover all software and supported a clarification to exclude purchases of nonexclusive licenses to use commercially available software. We also recommended that Congress adopt an explicit amortization period for such licenses, perhaps patterned after the Internal Revenue Service's administrative safe harbor, Rev. Proc. 69–21, 1969–2 C.B. 303, which generally provides an amortization period of up to 5 years for software that is purchased separately and treats the cost of software included in the purchase price of a computer as part of the depreciable basis of the computer.

Under H.R. 4210, computer software is not subject to the 14-year amortization period if it is offered on a nonexclusive basis to the general public and has not been substantially modified for the user. Excluded software is generally treated in the same manner as under current law, except that if it is subject to depreciation under section 167, it is to be amortized over a 36-month period. This exclusion for nonexclusive licenses to use commercially available software is consistent with the suggestions in our prior testimony and we support this change.

In addition, H.R. 4210 provides an exclusion (and 36-month amortization) for computer software that is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. As we understand the intent of this provision, it will generally apply when software is acquired unaccompanied by material ancillary business assets, such as a workforce, equipment and trademarks. We believe such an exclusion is consistent with H.R. 4210's treatment of patents, copyrights and similar intellectual property. Therefore, we also support this change.

Mortgage servicing contracts. H.R. 3035 and H.R. 4210 both provide that customer-based intangibles are subject to 14-year amortization. H.R. 4210 clarified that the 14-year amortization rules do not apply to the acquisition of interests under existing indebtedness. Its legislative history explains that this exception includes rights under a mortgage servicing contract to the extent the rights are treated as stripped coupons (i.e., debt) under applicable law. We believe that this change is consistent with the initial legislation, and we support it. In this connection, it may be appropriate to clarify whether the free-standing purchase of a mortgage servicing contract should be entirely excepted from 14-year amortization.

Films, sound recordings, videotapes and books. Under H.R. 3035, there was some concern that free-standing purchases of interests in films, sound recordings, videotapes, books and similar property would have been subject to 14-year amortization. H.R. 4210 makes clear that such interests are excluded unless they are acquired in a transaction (or series of related transactions) that involves the acquisition of assets that constitute a trade or business or a substantial portion of a trade-or business. We do not oppose this provision.

We also note that if this exclusion is adopted, Congress may wish to consider coupling it with a provision modifying the income forecast method of depreciating films. Changing the income forecast method so that it clearly reflects the income of film purchasers is appropriate on its own merits. It would contribute to the bill's overall revenue neutrality.

Government contracts. H.R. 3035 excluded from 14-year amortization all licenses, permits, and other rights granted by a governmental unit or agency thereof. In our testimony last October, we supported this exclusion of government-granted rights of an indefinite duration on the ground that such rights are effectively perpetual in nature. H.R. 4210 would provide 14-year amortization for government-granted licenses, permits and other rights. Since our prior testimony, we have been persuaded that as a result of technological advances and other circumstances, the economic value of certain perpetual government-granted rights may have a finite, if indeterminable, economic life. In addition, as noted above, we believe the classes of intangibles excluded from 14-year amortization should be strictly limited. Therefore, we no longer oppose 14-year amortization for government-granted rights.

Retroactivity. H.R. 4210 differs significantly from H.R. 3035 in its effective date provisions. H.R. 3035 was entirely prospective; it applied only to property acquired after the date of enactment. H.R. 4210, on the other hand, includes two different forms of retroactivity. First, a taxpayer may elect to apply the bill to all property

acquired after the date on which H.R. 3035 was introduced (July 25, 1991). We do not oppose this provision because it has permitted transactions to go forward in the face of pending legislation, and because all parties to affected transactions have been on notice and have been able to negotiate accordingly. Our lack of opposition is conditioned on covering the associated revenue cost and enactment of the underlying legislation this year (ideally, before taxpayers are required to file returns that would be affected by the election). Congress may also wish to consider changing the date from July 25, 1991 to October 2, 1991, because the latter was the date when Congress formally stated its intention to provide some form of elective application.

Alternatively, a taxpayer may elect to apply the bill to all property acquired in taxable years that were open on July 25, 1991, unless a year subsequent to the open year was closed on that date. If a taxpayer elects to apply the bill retroactively to all open years, intangibles the taxpayer acquired on or before the date of enactment are amortized ratably over 17 (rather than 14) years, and the Internal Revenue Service is not required to pay interest on any overpayment that results from the election. In addition, the Internal Revenue Service is not allowed to change the taxpayer's method of amortizing certain intangibles that were acquired in closed years.

We oppose this latter form of retroactive application on revenue and policy grounds. Recent information suggests that, as a result of this provision, H.R. 4210 would lose significant revenue.

From a policy standpoint, the Administration has consistently opposed elective retroactive application of the statute. We recognize that there are numerous controversies between taxpayers and the Internal Revenue Service concerning the amortization of intangibles, and that there will be more to come for years prior to 1992. These disputes are costly to the private sector and the Government. We share Congressional concern over the prospect of continued litigation gridlock, particularly over issues of no ongoing significance. We would readily embrace a legislative solution that would resolve all open cases fairly, equitably, immediately, and at no additional cost to taxpayers and the Government.

Unfortunately, no legislation can achieve these objectives. While it is not a perfect solution, we believe that the best course of action is to encourage taxpayers and the Service to act promptly and reasonably in resolving existing disputes, and provide continued congressional oversight until the stables have been cleaned.

We are particularly troubled by the current version of elective retroactivity:

(1) The provision would not achieve its stated purpose of resolving pending controversies. Because it is elective, taxpayers who believe they have marginal cases (or would enjoy a clear windfall) will elect retroactive application, but taxpayers who believe they have strong arguments for amortizing intangibles over periods shorter than 17 years will continue to litigate.

(2) The provision would confer substantial windfall benefits on certain taxpayers who engaged in purchase transactions involving significant amounts of goodwill—they will be far better off than they would have been under even the most pro-taxpayer application of existing law. For example, consider a leveraged buy-out transaction dating back many years, which was priced on the basis that goodwill could not be amortized. All of the benefits of a retroactive election to amortize goodwill over 17 years would accrue to the purchasers; no benefits would accrue to the selling public shareholders.

If Congress feels compelled to legislate some form of retroactive application, we urge you to consider questions such as the following:

- In order to achieve the stated purpose of resolving all pending controversies, would it be possible or appropriate to provide for some type of mandatory retroactive application in all purchase transactions (perhaps subject to a dollar threshold)?
- In order to prevent windfall benefits, would it be possible or appropriate to limit taxpayers to the value of write-offs reflected in their return positions, or to some discounted percentage of that amount to reflect litigation hazards, or to exclude amounts initially classified by the taxpayer as goodwill (recognizing that this approach would reward aggressive behavior)?
- Should taxpayers who failed to elect purchase treatment be permitted to do so in light of the retroactive law change?
- Given that taxpayers will only elect retroactively when they perceive it to be to their benefit, would it ever be possible to achieve a recovery period that is truly revenue neutral?

This concludes my testimony, Mr. Chairman. We will be pleased to answer any questions which you or other members of the Committee may have, and look for-

ward to working with you to achieve this all important step down the road-of tax simplification.

Attachment.

RESPONSES OF MR. GOLDBERG TO QUESTIONS SUBMITTED BY SENATOR GRASSLEY

Question No. 1. What impact will proposals requiring the amortization of intangibles over a 14 year period have on mortgage lenders that purchase servicing rights that, in many instances, currently have much less than a 14 year amortization period? Will the housing market be adversely affected at all?

Response. As your question suggests, 14-year (or 16-year) amortization of purchased mortgage servicing rights is generally less favorable than the treatment of those rights under current law. Moreover, we recognize that this less favorable treatment may constitute a particular hardship for taxpayers whose principal business is mortgage servicing. In my testimony on this issue, I said that we supported an exception from the generally applicable amortization period for rights under a mortgage servicing contract to the extent the rights are treated as stripped coupons under applicable law. I also noted that it might be appropriate to clarify whether the free-standing purchase of a mortgage servicing contract should be entirely excepted from the generally applicable amortization period. H.R. 11, as approved by the Finance Committee, provides such an exception.

As to the effect of intangibles legislation on the housing market, we have no reason to expect any adverse impact. Although particular intangible assets will be treated less favorably than under current law, other intangible assets will benefit from the change. Moreover, a uniform amortization period will provide greater certainty and eliminate a major source of waste, inefficiency, and controversy. Thus, the effect of the legislation on a broad sector of the economy, such as the housing market, should be generally beneficial.

Question No. 2. If the problem regarding current disputes is addressed, shouldn't we allow taxpayers to amortize intangibles even if the period of assessment has expired but the taxpayer has paid the alleged deficiency and filed a claim for refund within the allowable amortization period? In other words, shouldn't the definition of "open year" be expanded to include these situations where a refund is claimed?

Response. The Administration has consistently opposed the elective retroactive application of intangibles legislation to open years. If, however, Congress feels compelled to legislate some form of retroactive application, we do not believe there are policy grounds, other than revenue considerations, for a distinction between intangible issues that are open because the generally applicable period for assessment has not expired and those that are open solely because a claim for refund has been filed with respect to the intangible. We note that H.R. 11, as approved by the Finance Committee, treats a year as open if, as of June 16, 1992, the taxpayer had a pending claim for refund involving intangible issues.

Question No. 3. If the current dispute problem is not addressed, to what extent should we consider the reasonable expectations of the parties that relied on amortizing intangibles in calculating the purchase price of an intangible asset?

Response. The Administration believes that taxpayers generally should be able to rely on the tax law as it exists at the time of a transaction in determining the tax consequences of the transaction, and it has supported prospective-only effective dates in this and other instances for that reason.

PREPARED STATEMENT OF ORRIN G. HATCH

Thank you Mr. Chairman. I would like to commend you for holding this hearing on the timely subject of the amortization of intangible assets.

We have seen the need for simplification and clarification of the tax code concerning the tax treatment of intangible as sets grow significantly in the last several years with the total value of reported intangible assets jumping nearly sixfold between 1980 and 1987 from $45 billion to $262 billion.

The amortization of these intangible assets has become an area of conflict and frequent litigation between the IRS and the taxpayer. According to a General Accounting Office report released in August 1991, IRS auditors challenged $23.5 billion in intangible deductions in 1989.

At the heart of this conflict is the definition of goodwill. In 70 percent of these cases, the IRS claims that the intangible asset is actually part of goodwill and therefore could not be written off. A clarification of existing law is needed to encourage settlement of existing controversies on a basis that is fair to both taxpayers and the

IRS. Failure to clarify the law would mean that the proper treatment of intangible as sets acquired by taxpayers would remain in doubt, pending costly litigation.

In the long run, a legislative solution is likely the best answer in bringing some order to the tax treatment of these assets. The bills we are discussing today all have the same goals of clarification and simplification. Yet, they take several different approaches in reaching this goal, ranging from clarifying that amortization of the asset is allowed if a value and reasonable life can be determined for that asset, to setting a 14 year amortization period for all intangible assets, including goodwill.

Several controversies and concerns regarding the amortization of intangible assets are not addressed by the legislation before us today, however. For instance, some of this legislation would apply retroactively to purchases already made. Is this good tax policy?

Then, there is the question of how to treat high technology assets such as software and electronics. These high-tech items obviously do not have a useful life of anywhere near 14 years, and have been given a useful life by the IRS of five years or less. Increasing the amortization period would increase the cost of software products to consumers and the cost of acquiring new technologies. This would drive up development costs and recovery periods, making U.S. companies less competitive with their international rivals According to former Treasury Undersecretary Nornan Ture, a 14 year amortization period would raise the cost of using software to U.S. firms by 16.6 percent to 23.1 percent depending upon a firm's tax circumstances. While we all know that there are going to be winners and losers in any compromise that is reached, we must examine the effects on all industries and ensure that one industry is not disproportionately affected by any legislation passed by this Committee.

The treatment of disposition gain or loss for the assets must also be addressed. We must be careful that we are not just pushing the audit issue back until the intangibles are sold or become worthless. This will not help simplify the tax code or clarify Congressional intent.

Intellectual property is another area of extreme concern. We saw this in the tax legislation recently vetoed by the President. The intangibles provision that became part of that bill made clear that interests in films, sound recordings, videotapes, books, software, and similar property were not to fall within the general rule of the bill. I think it makes good sense for us to adopt that same approach in any legislation passed by this Committee. Otherwise, our intellectual property industries, a prized American trade asset, may be unnecessarily disrupted.

Any simplification proposal is going to involve trade-offs and the amortization of intangibles is no different. There will be both winners and losers in all of the legislation we are discussing today. What we must do is study those tradeoffs and decide which approach will best simplify the tax code and give the taxpayers some certainty about the tax treatment of intangibles while maintaining the competitive ability of American companies in the global economy. This hearing today is the first step in that process and I look forward to hearing the testimony of the witnesses today and their insights into the issue before us.

Thank you Mr. Chairman.

Prepared Statement of Kenneth J. Kies

I. Introduction

The Amortization of Intangibles Task Force (the "Task Force") consists of industry trade associations and corporations representing almost 500,000 insurance agents throughout the United States. Its members include the Independent Insurance Agents of America, the National Association of Insurance Brokers, the National Association of Professional Insurance Agents, and the National Association of Casualty and Surety Agents. It is committed to the proper Federal tax treatment of intangible assets, in particular as relates to customer-based intangibles, including customer lists and insurance expirations.

The Task Force supports enactment of S. 1245, the "Amortization of Intangibles Clarification Act of 1991," originally introduced by Senators Daschle and Symms and currently cosponsored by 19 Senators, including 5 members of the Senate Finance Committee. S. 1245 would clarify existing law for all open tax years in a manner that is consistent with (1) many of the judicial decisions that deal with the amortization of customer-based intangibles, (2) the reasonable expectations of most taxpayers who acquired these assets, and (3) the decision of the Senate Finance Committee in 1987 to reject legislation which would have eliminated amortization of customer-based intangibles. The Task Force also supports enactment of similar legisla-

tion currently pending in the U.S. House of Representatives, H.R. 1456, currently cosponsored by 186 House members.

The Task Force also supports enactment of Section 4501 of H.R. 4210, the "Tax Fairness and Economic Growth Act of 1992." The genesis of this legislation is H.R. 3035, Chairman Rostenkowski's legislative proposal to simplify the tax treatment of intangible assets. This legislation would generally provide for the 14-year amortization of intangibles and goodwill. It would achieve a significant simplification of the tax law for many transactions by both eliminating the need to allocate purchase price between goodwill and amortizable intangibles and eliminating controversies over the proper recovery period for such assets.

The Task Force's support for the 14-year rule of Section 4501 of H.A. 4210 is contingent upon inclusion with that proposal of legislation which will clarify existing law for intangible assets acquired prior to July 25, 1991, in a manner which is consistent with the reasonable expectation of taxpayers who previously acquired these assets. That expectation, that these assets would be amortizable if the taxpayer could demonstrate fair market value and useful life, has been retroactively jeopardized by the position which the Internal Revenue Service ("I.R.S.") has taken in its Coordinated Issue Paper on this topic. The Task Force believes that this result could be accomplished by applying the concepts of S. 1245 to assets acquired prior to July 25, 1991. The Task Force also believes that the approach taken to addressing the problems with respect to previously acquired assets by the 17-year rule of Section 4501 is acceptable, however, the 17-year period should be conformed to the general 14-year rule of the legislation.

We strongly believe that a clarification of existing law is needed to encourage settlement of existing controversies on a basis that is fair to both taxpayers and the I.R.S. The clarification of existing law offered by S. 1245 regarding the treatment of intangible assets would not offend traditional notions of fairness that usually weigh against enacting tax legislation which applies to prior transactions because it would be consistent with the expectations of taxpayers when those assets were acquired that those assets would be amortizable if taxpayers could reasonably demonstrate their fair market value and useful life. Those expectations were reasonable for the following reasons:

- The historic tax policy explanation for prohibiting the amortization of goodwill is that it has an indeterminate useful life. In light of this historic basis, it was clearly reasonable for taxpayers to believe intangible assets with identifiable ulseful lives and fair market values could be amortized.[1]
- Permitting the amortization of intangible assets with fair market values and useful lives is consistent with the fundamental net income basis for computing tax liability under the Federal income tax system. Not permitting amortization of an intangible asset that generates a stream of income effectively results in a gross income tax system.
- The expectation of taxpayers which existed prior to 1987 was reinforced by the decision of the Senate Finance Committee, and ultimately the Congress, in 1987 to reject a proposal by the staff of the Joint Committee on Taxation to prohibit the amortization of intangible assets. The Joint Committee staff projected that this proposal would increase revenues by $320 million for the 1988–90 period. Interestingly, the Joint Committee staff, described current law in a way which was clearly consistent with the belief of taxpayers that assets that had determinable lives and fair market values were amortizable:

> Taxpayers may take depreciation or amortization deductions for the exhaustion, wear, tear, and obsolescence of property (sec. 167(a)). No such deductions are allowed, however, with respect to property that is not a wasting asset or property whose useful life cannot be estimated with reasonable accuracy. Deductions are generally allowed for the costs attributed to such intangible assets as patents or other statutory or contract rights that exist for specific, non-extendible period of time. However, *because goodwill does not have a determinable useful life,* no depreciation deduction is allowed with respect to that intangible asset. Accordingly, the portion of the purchase price of a business that is allocated to goodwill may not be amortized or depreciated. Goodwill has been defined as the expectancy of continued

[1] Moreover, the historic judicial basis for prohibiting the amortization of goodwill is factually peculiar at best, involving a United States Supreme Court case involving the amortization of goodwill associated with a brewery following enactment of prohibition. *Clark* v. *Haberle Crystal Springs Brewing Company,* 280 U.S. 38A (1930). It appears this was a clearly result driven decision which was reached with little attention to sound tax policy.

patronage, for whatever reason, or as "the probability that old customers will resort to the old place."[2]

- Prior to the issuance of the Coordinated Issue Paper, the general I.R.S. practice and procedure was to settle controversies with taxpayers involving intangible assets by negotiating over the fair market value and useful life, not to disallow amortization entirely.
- Many judicially-decided controversies involving taxpayers were resolved by permitting the amortization of customer based intangibles over their useful lives and fair market values.
- Representatives of the I.R.S., Treasury Department and the Justice Department all concede, at a minimum, that the state of the law in this area is confused. For example, the Solicitor General, in *not opposing* the petition for writ of certiorari of the taxpayer in the *Newark Morning Ledger* case which the U.S. Supreme Court recently agreed to hear, stated as follows:

> We agree with petitioner, however, that this case involves a recurring issue of substantial administrative importance that has given rise to inconsistent reasoning and inconsistent decisions among the circuits. We therefore do not oppose the granting of certiorari in this case.

II. THE I.R.S. COORDINATED ISSUE PAPER

The Task Force was originally formed in 1987 in response to legislation considered by the Congress as part of the Omnibus Budget Reconciliation Act of 1987 which would have provided, as a matter of law, that customer-based intangibles and similar items were nonamortizable. The Task Force at the time, along with many other affected taxpayers, vigorously argued that adoption of such legislation, would distort economic income by preventing the recovery of the cost of what clearly are wasting assets. The Senate Finance Committee rejected this proposal, and ultimately, the Conference on the 1987 legislation rejected the House proposal which would have provided for this result. *Conference Report of the Omnibus Budget Reconciliation Act of 1987 to Accompany H.R. 3545*, Report 100–495 (1987) at 936–38.

The Task Force again became active last year in response to the issuance by the I.R.S. in 1990 of a Coordinated Issue Paper regarding the amortization of customer-based intangible assets. The Coordinated Issue Paper takes the position, as a matter of law, that intangible assets that are customer-based and are acquired in an acquisition where goodwill or going concern value is also acquired, are *per se* nonamortizable. The Task Force believes the Coordinated Issue Paper is an incorrect statement of current law, represents bad tax policy, represents a retroactive change of position by the I.R.S. in this area and represents an attempt to accomplish administratively what the Congress rejected as a legislative proposal in the 1987 budget reconciliation legislation. Under current law, intangible assets are amortizable, provided that such assets have an ascertainable value separate and distinct from goodwill and going concern value, and such assets have a reasonably determinable useful life. It believes enactment of S. 1245 would put to rest the controversy caused by the Coordinated Issue Paper. Therefore, the focus of our statement will be on the need to clarify existing law with respect to customer-based intangible assets.

III. CURRENT LAW

The current state of the law regarding the amortization of intangible assets generally is based upon Treasury Regulations and case law. Although the Treasury Regulations do not specifically address *customer-based* intangibles, they do set forth rules with respect to intangibles in general. Treasury Regulation §1.167 (a)–3 provides that:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. . . . No deduction for depreciation is allowable with respect to good will.[3]

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[2] Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means, Staff of the Joint Committee on Taxation (1987) at 146.

[3] Treas. Reg. §1.167(a)-3 corresponds in part to §167(a) of the Code. Section 167(a), however, does not specifically prohibit the amortization of goodwill.

Simply stated, therefore, as long as an intangible asset has a limited useful life that can be estimated with reasonable accuracy, a depreciation deduction will be allowed, but no deduction Is permitted for goodwill.

The above regulation has provided the basis for a significant body of case law regarding amortization of customer-based intangibles. For some time, the major case on this issue has been *Houston Chronicle Publishing Co.* v. *U.S.*, 481 F.2d 1240 (5th Cir. 1973). That case involved an acquisition of the assets of a daily newspaper by the Houston Chronicle Publishing Co. (the "Chronicle"). The acquired assets included all of the target corporation's subscription lists, the cost of which The Chronicle amortized for tax purposes over a period of five years. The I.R.S. disallowed the amortization deductions, arguing that customer-based intangibles are inseparable from goodwill and, therefore, are nonamortizable as a matter of law. The I.R.S. argued for a "mass asset rule," that customer lists are presumed to be a part of goodwill, and thus nondepreciable.

The Fifth Circuit held in favor of the taxpayer. First, it rejected the I.R.S.'s "mass asset" theory in favor of a facts-and-circumstances test. In so doing, the court stated:

> We reject . . . the establishment of a *per se* rule and a monolithic "mass asset" theory that would amalgamate all subscription lists with goodwill.
>
> Our view—that amortizability for tax purposes must turn on factual bases—is more in accord with the realities of modern business technology in a day when lists are bartered and sold as discrete vendible assets. Extreme exactitude in ascertaining the duration of an asset is a paradigm that the law does not demand. All that the law and regulations require is reasonable accuracy in forecasting the asset's useful life. *Id. at 1253, 1254.*

The Fifth Circuit in *Houston Chronicle* also formulated the following two-pronged test that must be satisfied by taxpayers in order to amortize an intangible asset:

> intangible capital assets . . . may be depreciated for tax purposes if taxpayer sustains his burden of proving that [they] (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy. *Id.* at 1251.

The test has been applied by many courts throughout the U.S. since 1973.

Not only is the two-pronged *Houston Chronicle* test followed by courts throughout the country, it also was the stated published position of the I.R.S. prior to the issuance of the Coordinated Issue Paper. In the year following *Houston Chronicle,* the I.R.S. issued Rev. Rul. 74–456, 1974–2 C.B. 65, in which it acted on a request to reconsider its positions previously set forth in Rev. Rul. 65–175, 1965–2 C.B. 41, and Rev. Rul. 65–180, 1965–2 C.B. 279. Those two prior rulings concluded that the value of existing insurance policies and insurance expirations were deemed to constitute goodwill, the cost of which was nonamortizable. Relying on *Houston Chronicle,* Rev. Rul. 74–456 stated:

> Rev. Rul. 65–175 and Rev. Rul. 65–180 are modified to remove any implication that customer and subscription lists, location contracts, insurance expirations, etc., are, as a matter of law, indistinguishable from goodwill possessing no determinable useful life. The depreciability of assets of this nature is a factual question, the determination of which rests on whether the taxpayer establishes that the assets (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy. *Id.* at 66.

That the above statement precisely follows the holding of *Houston Chronicle* made it clear that the I.R.S. agreed, at least publicly, with the legal standard set forth in that case.

In the more recent case of *Newark Morning Ledger Co.* v. *U.S.*, No. 90–5637 (3rd Cir. 1991), reversing 734 F.Supp. 176 (D.N.J. 1990), a similar issue was decided in favor of the I.R.S. The Third Circuit there held that the taxpayer had not met its burden of establishing that newspaper subscription lists were separate and distinct from goodwill. We believe that case was incorrectly decided for a variety of reasons including, but not limited to, the fact that the lower court clearly found as a factual matter that the taxpayer had demonstrated the value of the customer lists separate and distinct from goodwill. Moreover, there was no evidence in those findings to support the apparent conclusion of the Third Circuit that there was reversible

error.[4] Finally, as indicated later in this testimony, this result is clearly inconsistent with sound tax policy. The United States Supreme Court has recently agreed to review the decision of the Third Circuit in *Newark Morning Ledger* case but a decision is not expected until February of 1993.

The case of *Panichi* v. *U.S.*, 834 F.2d 300 (2d Cir. 1987) involved a similar type of intangible, a customer list. There, the taxpayer had purchased a small portion of a trash collection company's list of customer routes as well as some other equipment. Other purchasers obtained the remaining route lists. The I.R.S. argued that the lists were, as a matter of law, inseparable from goodwill. However, the Court of Appeals affirmed the District Court's finding that the customer list "had a discrete value, apart from goodwill . . . ." *Id.* at 301.

In other contexts as well, taxpayers have been able to identify an intangible asset value separate and distinct from goodwill. *See, Computer & Software. Inc.* v. *Commissioner,* 64 T.C. 223 (1975) (involved the amortization of credit information files in the context of an acquisition of three credit reporting companies); *Citizen & Southern Corp.* v. *Commissioner,* 91 T.C. 463 (1988) (amortization of core deposit bases, acquired by the taxpayer in the purchase of several banks); *Richard Miller & Sons. Inc.* v. *U.S.*, 547 F.2d 446 (Ct. Cl. 1976) (amortization of insurance expiration lists acquired as part of insurance agency business); *Manhattan Co. of Virginia. Inc.* v. *Commissioner,* 50 T.C. 78 (1968), (amortization of list of home pick-up and delivery laundry customers permitted); and *Donrey. Inc.* v. *U.S.*, 809 F.2d 534 (8th Cir. 1987).

IV. AMORTIZING CUSTOMER-BASED INTANGIBLE ASSETS IS CONSISTENT WITH THE BASIC TAX POLICY OBJECTIVE OF MATCHING INCOME AND EXPENSE

As an economic matter, the purchaser of an ongoing business with stable, existing customer relationships expects to earn a quantifiable income stream from those existing customer relationships, and can usually project with reasonable certainty the average expected remaining useful life of those specific, identifiable customer relationships. The purchase price for the business invariably takes into account these customer relationships and the projected income stream, just as the purchase price takes into account the value of tangible personal property. The purpose of depreciation and amortization deductions is to facilitate the proper reporting of taxable income on a net income basis, by permitting taxpayers to offset the costs of capital expenditures for wasting assets against the income generated by those assets. As a matter of sound tax policy, a taxpayer should be entitled to amortize its acquisition cost for customer-based intangible assets, regardless of whether those assets are acquired as part of an ongoing business, provided the taxpayer can factually demonstrate that the assets have a limited useful life, the duration of which can be estimated with reasonably accuracy, and an ascertainable value separate and distinct from goodwill.

V. THE TASK FORCE SUPPORTS ENACTMENT OF S. 1245

S. 1245, the "Amortization of Intangibles Clarification Act of 1991," originally introduced by Senators Daschle and Symms and currently cosponsored by 19 members of the U.S. Senate, would clarify that customer-based intangibles are amortizable under current law. The legislation is specifically intended to clarify current law in a manner consistent with numerous judicial decisions dealing with amortization of customer-based intangibles. S. 1245 would amend the Code to provide statutorily that the value of customer-based, market share and similar intangible assets are amortizable over their useful life if the taxpayer can demonstrate through any reasonable method that: (1) the intangible asset has an ascertainable value separate and distinct from other assets, and (2) the intangible asset has a limited useful life, the length of which can be reasonable estimated.

S. 1245 would apply to all open tax years. We note that the Department of the Treasury has decided not to support S. 1245, in part because it traditionally opposes "retroactive" legislation. However, although S. 1245 would apply to all open tax years, its provisions would not adversely affect taxpayers who consummated transactions in reliance on the tax law then in effect. As a clarification of existing law, made necessary because of the extreme position taken by the I.R.S. in the Coordinated Issue Paper, S. 1245 would bring certainty to the law and reduce costly controversies. Moreover, we would note that testimony provided at the hearing of the Ways and Means Committee on this issue on October 2, 1991, clearly indicates that there is an abundance of confusion as to the exact current status of the law, particu-

[4] The members of the Task Force filed an amicus brief in the U.S. Supreme Court in support of the petition for writ of certiorari by the taxpayer.

larly in light of the I.R.S. position. Normal concerns with respect to retroactivity turn on the fact that changing an existing rule is inappropriate. Such a position is not defensible when the objective is to bring clarity to a situation ripe with controversy and confusion. This point is discussed in more detail in section VII of this testimony.

VI. THE TASK FORCE SUPPORTS THE ENACTMENT OF H.R. 3035

Section 4501 of H.R. 4210 would add new section 197 to the Code, which would specifically allow the amortization of goodwill and most customer-based intangible assets. A uniform 14-year amortization period would apply to all eligible intangible assets. Thus, there would be no incentives, for either taxpayers or the I.R.S., to misclassify acquired assets.

This legislation should include provisions to encourage settlement of existing disputes between taxpayers and the I.R.S. Making principles of S. 1245 applicable to assets acquired prior to July 25, 1991, would accomplish this result. Consideration should also be given to other possible revenue neutral elections available to taxpayers intended to encourage settlement. For example, an election permitting taxpayers to amend open returns for a 1-year window period following date of enactment to elect the longer of a 10-year recovery period or the period of recovery claimed on the originally filed return may satisfy this objective. As indicated earlier, the 17-year rule of Section 4501 of H.R. 4210 would also be an appropriate approach to this problem.

VII. LEGISLATIVE SOLUTION WITH RESPECT TO PREVIOUSLY ACQUIRED ASSETS IS NEEDED

As indicated earlier, some concerns have been raised with respect to the appropriateness of including with any intangibles legislation enacted, provisions which apply to assets acquired prior to the effective date of the legislation. This issue has on occasion been referred to as the "retroactivity" issue. We believe that this characterization of the issue, and the concerns that have been raised with respect to it, are misplaced. Moreover, we strongly believe in light of the I.R.S.'s position in this matter, and the substantial number of controversies pending in this area, that it is highly appropriate and desirable for the Congress to include provisions with respect to assets acquired prior to date of enactment which will ensure that taxpayers receive tax treatment with respect to these assets which is consistent with the reasonable expectations which they had when these assets were acquired. Several points support this conclusion.

First, the retroactivity that exists in the current situation is a consequence of the I.R.S.'s intangible assets Coordinated Issue Paper which was issued sometime in 1990. The Coordinated Issue Paper substantially changed the pattern and practice of the I.R.S. in this area in a manner that retroactively affected assets of taxpayers acquired in previous transactions. Moreover, the position of the I.R.S. is wholly inconsistent with the reasonable expectations which taxpayers had when they acquired these assets, i.e., that these assets would be amortizable if taxpayers could demonstrate their fair market values and useful lives.

Second, the normal concerns with respect to retroactivity from a tax policy perspective do not apply in this case. There is no windfall that taxpayers will experience to the extent that provisions applicable to previously acquired assets simply provide them with the expectation that they had at the time of the acquisition, i.e., that the assets would be amortizable over their useful life if the taxpayer could demonstrate the fair market value.

Third, the controversy over the 17-year provision contained in Section 4501 of H.R. 4210, the "Tax Fairness and Economic Growth Act of 1992," is a consequence of the fact that that provision would permit amortization of goodwill. However, the 17-year recovery period that would be permitted for goodwill and other intangibles is substantially longer than the average period claimed with respect to the non-goodwill intangible assets alone. In fact, many taxpayers who would chose the 17-year provision would experience a net tax penalty even though they would be permitted to amortize goodwill. This phenomenon, inconsistent with the normal adverse selection analysis that would suggest that taxpayers would only elect the 17-year provision if it provided them with a better result than they have claimed on their returns, occurs because taxpayers are willing to pay a premium to attain certainty and to avoid the cost of funding a controversy with the I.R.S. These costs frequently are substantial, involving lawyers, accountants, and valuation experts.

Finally, it is abundantly clear that there is a crying need to provide a legislative solution to the substantial number of controversies that are currently pending between the I.R.S. and taxpayers in light of the state of confusion as to existing law

which exists. It is difficult to understand how anyone could argue that a clarification of the law in a manner intended to resolve expeditiously controversies between taxpayers and the government on a reasonable basis should be considered retroactive in a climate where even the government's own representatives admit that the current state of the law is thoroughly confusing. For these reasons, a clarification of the law with respect to previously acquired assets should be included with any legislation enacted in this area to encourage the fair and expeditious settlement of these controversies.

We thank the Committee for its attention and the opportunity to testify today.

PREPARED STATEMENT OF LEONARD PODOLIN

INTRODUCTION

Thank you, Mr. Chairman, for the invitation to testify today on behalf of the American Institute of Certified Public Accountants ("AICPA") and its over 300,000 members. I am Leonard Podolin, Chairman of the Tax Executive Committee of the AICPA. Joining me today is Lerin Luchs, Chairman of the special task force formed by the AICPA Tax Division several years ago to study the issue of amortization of intangible assets.

The allowance of intangible asset amortization is a major concern to American businesses, especially service-oriented businesses whose revenues are often dependent on the use of intangible assets (such as know-how, contractual relationships, and customer lists) to the same extent manufacturing businesses are dependent on the use of tangible assets such as machinery. This area is also a major concern to businesses that must compete with non-U.S. based companies whose tax laws allow goodwill and other intangibles to be amortized. Legislation eliminating the conflict that has developed between the Internal Revenue Service ("IRS") and businesses over amortization of intangible assets is greatly needed and will help simplify the tax system. As you know, the AICPA has been a strong proponent that our tax laws be simplified.

LEGISLATIVE ALTERNATIVES

In March 1990, we described to the GAO three possible legislative alternatives regarding intangible assets:

1. The tax law can be amended to eliminate any amortization deduction for intangible assets;
2. The tax law can be amended to prescribe the types of intangible assets that can be amortized and the number of years over which qualifying intangible assets can be amortized; or
3. The tax law can be retained as is so that the present rules regarding amortization of intangible assets contained in the Code, regulations and case law remain.

We could not recommend the first legislative alternative because we believe the same policy reasons for allowing a depreciation deduction for tangible assets justify an amortization deduction for intangible assets. Like tangible assets, intangible assets are wasting assets that businesses must replace. Accordingly, we do not favor any legislation, or court decision (see discussion of *Newark Morning Ledger Co.* v. *U.S.* below), which would deny an amortization deduction for customer base or similar intangibles.

We believed there was considerable merit to the second alternative. However, we were concerned that designating the number of years over which qualifying intangible assets including goodwill are to be amortized may not satisfactorily take into account differences between types of businesses and industries. Furthermore, a material difference in the number of years allowed for amortizing goodwill versus other intangibles would not end the controversy and litigation over whether a claimed separate intangible was instead part of goodwill.

Accordingly, we recommended to the GAO that legislative changes to existing law regarding amortization of intangible assets not be made until the revenue effect of existing law could be determined in light of the changed acquisition environment caused by the repeal of the *General Utilities* doctrine. Our recommendation was based upon the belief that repeal of the *General Utilities* doctrine would decrease asset purchases and increase stock purchases not accompanied by a section 338 basis step-up election.

SUBSEQUENT DEVELOPMENTS

Since March, 1990, controversies between the IRS and taxpayers regarding the treatment of intangibles acquired as part of a trade or business have continued and, in fact, appear to have increased. Settlements have become more difficult to reach. These controversies have led to more taxpayer uncertainty regarding the proper tax treatment of acquired intangibles. Moreover, the September, 1991 Third Circuit U.S. Court of Appeals decision in *Newark Morning Ledger Co.* v. *U.S.*, currently on appeal to the Supreme Court, has increased taxpayer uncertainty in this issue. In that case, the IRS and the Third Circuit conceded that the subscription list acquired had an ascertainable value and a limited useful life (therefore was a wasting asset); but the Third Circuit still found that the subscription list constituted nonamortizable goodwill. (If the Supreme Court affirms the Third Circuit in *Newark Morning Ledger Co.*, we strongly believe legislation will be needed to correct this inequitable result).

As a result of these developments, we supported H.R. 3035 introduced in the House of Representatives on July 25, 1991, provided three changes to the legislation were made. One change, that a "section 197 intangible" subject to 14-year amortization only include intangible assets purchased as part of a trade or business, was adopted in large part in the revised legislation of H.R. 4210. Another change, that a section 197 intangible include renewable government rights (consistent with the holding in the recent Tax Court case, *Jefferson-Pilot Co.*), also was adopted in the revised legislation. Accordingly, we continue to support the amortization of intangibles legislation included as part of the simplification provisions in H.R. 4210 passed by the Congress on March 20, 1992, subject to one final revision discussed below relating to the treatment of dispositions of section 197 intangibles. Our decision to support legislation which provides a uniform amortization period for most types of intangible assets was made after carefully considering and balancing the following positive and negative effects we anticipate from enactment of such legislation.

Anticipated Positive Effects of the Legislation

- Reduce conflicts and litigation regarding intangible assets, provide more certainty, and simplify the tax laws in this area.
- Increase the certainty of the after-tax results of operations as reported in financial statements.
- Enhance competition with businesses of other countries because many other countries allow a deduction for goodwill for tax purposes.

Anticipated Negative Effect

The simplification resulting from a uniform 14-year amortization period will produce taxable income that does not take into account useful life and therefore does not match revenue and expenses. The 14-year amortization period is an arbitrary number that was selected based on revenue effects. Fourteen years does not relate to the useful lives of various types of intangible assets nor does it take into account differences among industry groups. Accordingly, some dislocation of tax burdens and possible inequities will result among taxpayers within the same and different industries.

We recognize that changing the proposed legislation to provide specific amortization periods for different intangible assets will not necessarily achieve the certainty and simplification aims. For example, a different amortization period for goodwill and customer lists will not necessarily end controversies over the identity and valuation of these two types of intangible assets. However, we urge the Committee to consider providing a different amortization period for all or categories of intangible assets of businesses in specific industry groups, consistent with the depreciation rules for tangible assets.

DISPOSITIONS OF SECTION 197 INTANGIBLES

As stated above, our support for the revised legislation included in H.R. 4210 is conditioned upon one final modification we believe is necessary for the legislation to achieve its intended purpose. We strongly believe a modification is necessary governing the tax treatment of gains and losses generated by dispositions of section 197 intangibles (proposed IRC sec. 197(f)(1)). To illustrate our concern with this provision, consider the following example:

Assume after enactment of the proposed legislation, X Corporation purchases the business and assets of Y Corporation, a manufacturer of medicine, drugs and over-the-counter health supplies. Y's many separate product lines include patents, trademarks and trade names with respect to the

products it manufactures. In years after the purchase, X determines that several of the acquired product lines are not meeting profitability expectations and discontinues their manufacture and sale. Several other product lines are likewise dropped in favor of expanding X's own brand name market share.

While X initially welcomed the certainty of 14-year amortization for all the section 197 intangibles it acquired, it will now find that the certainty and simplification it anticipated does not exist. Because some acquired intangible assets are now disposed of, it will be necessary for X to value each of the intangibles it purchased from Y in order to determine whether it has a gain (taxable) or a loss (nondeductible) on the sale or abandonment of some of the section 197 intangibles.

In short, any business that acquires intangible assets in a purchase of a trade or business will be well advised to undertake a contemporaneous valuation and allocation to each of the intangibles at the time of the acquisition, if there is any possibility one or more of those intangible assets may be disposed of. Further, the hoped-for certainty which would avoid ongoing controversy with the IRS will not occur, and we should anticipate continued litigation as to the correct amount of taxable gain or nondeductible loss to be reported.

To correct this unintended result, we recommend that the proposed legislation provide for the deferral of both gains and losses upon the disposition of a section 197 intangible when other section 197 intangibles acquired in the same or a related transaction are retained. In this manner, all section 197 intangibles can be accounted for as a single basket. To accomplish this objective, consistent with the purpose of the proposed legislation, the bill should provide that the total cost allocated to all section 197 intangibles acquired in a transaction or series of related transactions be reduced by the proceeds from a sale of a section 197 intangible. Gains would be deferred until that total cost is recovered, and losses would be deferred until the last section 197 intangible is sold, becomes worthless, or is abandoned.

ELECTIVE RETROACTIVE TREATMENT

As we testified before the House Ways and Means Committee, we are strongly in favor of legislation that includes elective retroactive treatment for open years. Taxpayers who previously purchased a trade or business should be given the opportunity to eliminate existing or potential disputes with the IRS regarding intangible assets, thus furthering the goal of simplification.

The revised legislation included in H.R. 4210 includes an election to apply 17-year amortization to intangible assets acquired during open tax years, but relieves the IRS from paying interest with respect to overpayments resulting from that election. While denying interest on tax refunds may be seen as necessary for obtaining the required revenue effect, we believe it is the wrong policy solution to the problem.

The purpose of interest is to compensate a party for the use by a second party of the first party's money. This fundamental principle is clearly set forth in Rev. Proc. 60–17:

> The underlying objective is to determine in a given situation whose money it is and for how long the other party had the use of it.

With limited exceptions, this rule has guided the legislature, the courts, and the IRS. Generally, the rule has worked well. In situations in which the rule produced inappropriate results, the courts (including the Supreme Court) have looked to this principle rather than the literal language of the statute. See, for example, *Manning v. Seel Tool and Box Co.*, 338 U.S. 561 (1950). Departures from this rule have caused significant controversy and administrative problems. Consider, for example, taxpayers' reaction to the proposed expansion of the 45-day interest free processing period in section 3103 of the House bill.

Athough we believe eliminating the payment of interest on tax refunds to meet revenue goals is bad tax policy, we will continue to support the legislation even if that provision remains unchanged because of our overriding belief that disputes will be significantly reduced by permitting elective retroactive treatment.

CONCLUSION

The AICPA supports enactment of the proposed amortization of intangibles legislation. We believe the legislation, if properly drafted, will alleviate much of the need to separately evaluate the identifiable intangible assets acquired as part of a continuing business, thereby facilitating business acquisitions and reducing costly disputes between taxpayers and the IRS. We urge that the legislation be properly

drafted to meet its intended purpose of tax simplification and that it not include further erosion of the concept of interest.

PREPARED STATEMENT OF DUANE SUESS

Good morning. My name is Duane Suess. I am Vice President, Taxes, of International Multifoods, a company engaged in the manufacture and distribution of food products for the food service-industry, and I appear today on behalf of an informal coalition of taxpayers who strongly support the intangible asset provision in H.R. 4210.

The group is broad-based and includes companies covering all sectors of the economy. It includes both large and small companies, from a wide variety of industries and from all regions of the country. Various members of the coalition manufacture, distribute, and sell foodstuffs and consumer products, and provide financial, insurance, medical, telecommunications, and transportation services. The one interest we all share is our strong support of the intangibles provision included in H.R. 4210—the tax bill passed by the Congress in March and vetoed by the President.

This bill would have allowed, in general, a 14-year amortization period for all newly acquired intangible assets and a 17-year amortization period for previously acquired intangible assets. A vital ingredient of the bill, and the key reason for its success in simplifying the tax system, is its treatment of goodwill, which would be treated like any other intangible asset.

I would like to make two basic points today. The first is that the bill would indeed accomplish its objective of simplifying and bringing more fairness to tax administration. The second is that this objective will be accomplished within a reasonable time frame only by including previously acquired intangible assets in the legislation. Both of these objectives can be accomplished without costing the government any revenue.

THE INTANGIBLES PROVISION IN H.R. 4210 WILL ACCOMPLISH ITS OBJECTIVES

The group strongly supports the intangibles provision as included in H.R. 4210. We believe the legislation is a significant step in achieving simplification and fairness, and we commend Congress for this innovative approach to this difficult issue.

The treatment of intangible assets under current law is unclear and, as a result, inequitable. Different taxpayers with similar facts are not treated consistently, and both the government and taxpayers are spending substantial resources to achieve these unsatisfactory results. This is a serious problem that needs to be solved now.

As many members of this committee will remember, at one time we had a depreciation system for tangible assets that was based on facts and circumstances. The Congress, in its wisdom, correctly decided that this system was overly complex, unfair, and administratively inefficient. Today's system of fixed lives for the depreciation of tangible assets, like the proposed treatment of intangible assets, resolves those problems.

A single life for all intangible assets is "rough justice." Some taxpayers will have assets with somewhat longer lives, others will have assets with shorter lives, and others will be able to amortize goodwill that previously was nondeductible. In exchange for a single life for all intangible assets, taxpayers and the government will have much desired certainty and efficiency. Valuation, allocation, and useful life questions will be virtually eliminated. Taxpayer and government resources will no longer be spent unproductively in an attempt to answer questions that have no clear answers.

In brief, the bill promotes fairness and economic efficiency, while at the same time greatly simplifying the tax system.

MEANINGFUL SIMPLIFICATION CAN BE ACHIEVED ONLY BY INCLUDING PREVIOUSLY ACQUIRED INTANGIBLES

H.R. 4210 would allow taxpayers to elect to amortize previously acquired intangibles over 17 years. This life was chosen to be revenue-neutral over the five-year budget window, according to staff revenue estimates.

The longer amortization period compensates for any "adverse selection" by taxpayers against the government. The purpose of the election is to end the greatest possible number of controversies. It would not be practical to address every conceivable fact pattern that could arise. Nevertheless, the open-years election does, in the aggregate, fairly balance the interests of the government and taxpayers.

Only a statutory election will provide the needed certainty, consistency, and fairness. Unless treatment of prior open years is provided through legislation, resolution of these issues will continue to be costly, inconsistent, and inequitable.

Past controversies cannot be resolved solely through guidance in the committee reports, or by encouraging the Internal Revenue Service to settle cases using the principles of the intangibles legislation. Only a statutory open-years provision encompassing *all* of the principles of the legislation, including the amortization of goodwill, will address the crux of the controversy. The General Accounting Office study of intangibles found that 70 percent of the controversies between taxpayers and the IRS did not turn on the valuation or useful life of an intangible asset, but whether the asset was separate and distinct from goodwill.

The decision that the Supreme Court will be making late this year or next in the *Newark Morning Ledger* case will not solve the problem. That case is about only one kind of intangible asset—customer lists. It will not resolve the controversies about other types of intangibles, or for taxpayers with different facts and circumstances. An open-years election, on the other hand, will take care of all types of intangibles. Regardless of how the Court decides *Newark Morning Ledger,* the open-years election is the only alternative that will solve this problem.

We believe this election is critical to accomplishing the legislation's objectives within the next several years. Amortization issues typically are raised only on audit, several years after tax returns are filed. Currently contested cases arise from transactions that occurred throughout the 1980s and even from the 1970s. Without the election, these cases will not be resolved for years, and not before significant resources have been spent by both the government and taxpayers. With the election, tax dollars and deficiency interest will be collected earlier. If the election is not included in the final legislation, cases will continue to clog the courts and their ultimate disposition will have no precedential value.

As this committee knows, retroactive provisions generally are controversial. Taxpayers complain about retroactive tax increases, and the government is concerned about the prospect of providing windfall benefits to taxpayers. The open-years election has also generated that type of controversy. Two issues have been raised: Some are concerned that the provision applies only to taxpayers with open tax years and is, therefore, inequitable; and some criticize the legislation because they believe taxpayers will derive an unwarranted "windfall benefit."

While there may be some inequities in not offering relief to taxpayers with closed years, administrative difficulties make such an approach impractical. Any legislation merely directing the IRS to settle current cases would be equally inequitable. We believe that limiting the election to open years is the only practical and appropriate solution.

The perception of "windfall" gains resulting from the amortization of goodwill is a complex issue that exists with both prospective and retroactive application. The only difference is who gets the benefit. Current owners of intangible assets that may be sold in the future could See the market value of those assets rise as a result of this legislation; when those assets are sold, prospective buyers may pay more because the uncertainty associated with amortization will be removed and previously unamortizable goodwill will be deductible (i.e., the sellers benefit). Owners of previously acquired assets may benefit because this same uncertainty on their acquisitions would be resolved (i.e., the buyers benefit).

We do not believe it is possible to accurately measure the amount of any "windfall" in either prospective or past acquisitions. The issue at the heart of the intangibles controversy—what intangible assets are distinguishable from goodwill—would first have to be resolved. Without applying a consistent set of assumptions to all taxpayers, any comparison would have little meaning.

For example, a conservative taxpayer might allocate $90 of a $100 premium to goodwill and $10 to customer lists. An aggressive taxpayer in a similar situation might allocate $90 to the customer lists and $10 to goodwill. With an open-years election, both these taxpayers would be treated equally, amortizing the $100 premium over 17 years. From goodwill becoming deductible, the conservative taxpayer appears to have a windfall tax saving of $30.60 (34 percent of $90), and the aggressive taxpayer only $3.40 (34 percent of $10). The aggressive taxpayer appears to have a smaller tax benefit than the conservative taxpayer. Considering all the controversy over what constitutes current law, which is the correct amount?

We are here today because we believe this legislation will help our companies. However, the benefit is not the simplistic view, represented by some, of millions of dollars in tax savings. The benefits for all affected taxpayers—large and small, throughout the country—are reduction in litigation costs and in management time spent on nonproductive issues. The tax benefits are less clear because it is difficult to agree on the point from which to measure. Some companies will pay more taxes

relative to the position taken on their tax returns as soon as the legislation is effective. That is, the 17-year life is much longer than asset lives actually claimed on their returns. We are willing to accept this life in exchange for certainty. Some companies will receive a tax benefit from being able to amortize goodwill. However, this benefit is the necessary part of the exchange for simplicity, and it is no different from the benefit that will be derived by buyers and sellers of intangible assets in the future.

In conclusion, we strongly support the amortization of intangible assets as included in H.R. 4210 and believe it to be one of the most important contributions to the simplification of tax administration in years. It will release IRS resources for use on more productive issues; it will free up management time and other resources for expanding operations, developing new products and creating new jobs.

Prepared Statement of Curtis Uhre

Good morning. My name is Curtis Uhre, and I am President of the Home Finance Coalition. The Home Finance Coalition is a trade association of mortgage servicers whose members service approximately $80 billion of home mortgages for approximately 1.6 million homeowners across the country.

The Home Finance Coalition is opposed to the inclusion of mortgage servicing rights in the Intangible Simplification section of the Tax Fairness and Economic Growth Act of 1992. The Coalition believes one should not take assets with known useful lives and artificially lengthen those lives to 14 years. In the case of mortgaging servicing rights, this means increasing the average life from approximately 7 years to 14 years.

The home finance industry has changed dramatically over the past years. It is now generally divided into three segments; the loan originator, the mortgage servicer and the mortgage investor. Every time a mortgage loan is originated and sold to Fannie Mae, Freddie Mac, GNMA or any other private investor, a mortgage servicing right is created. A mortgage servicing right is simply the right to receive a small portion, usually 25 to 50 basis points, of the interest income of the mortgage. In return, the mortgage servicer collects the monthly mortgage payments, pays the investor, and insures that the taxes and insurance are timely paid. The remainder of the loan is sold to the mortgage investor. In short, the loan is divided into two pieces, the first being the mortgaging servicing right and the remainder of the loan which is sold to the investor, normally one of the secondary agencies.

Usually, the mortgage originator in addition to selling the loan to the secondary agencies, will also sell the mortgage servicing right to an institution which specializes in servicing mortgages. These mortgage servicing rights are sold through all of the major Wall Street securities firms and other boutique companies who specialize in this market place. Last year, the rights to service approximately $200 billion dollars of mortgages were sold. This is a very active and liquid market.

At the time the mortgage loan is originated, the loan originator knows that he will be able to sell the mortgage servicing right for between 1 to 2 percentage points of the underlying mortgage. The mortgage originator effectively credits this amount to the home borrower at the time the loan is originated, thus, requiring the home borrower to pay less points or closing costs at the time the loan is originated.

Many industry experts believe that the proposed intangibles legislation would decrease the value of mortgage servicing rights by approximately 30%. Attachment A to the Coalition's testimony provides simplified documentation of what this would mean to the value of the mortgage servicing rights. By requiring a 14 year amortization instead of a normal 7 year amortization, the value of the mortgage servicing right for a $100,000 mortgage is decreased by 30%, or $500. This decrease in value will be passed on to the home borrower who will have to pay an, additional $500 for this $100,000 mortgage.

The net result of this legislation then would be to decrease the value of mortgage servicing rights, and thus, increase the borrowing costs for the home borrower. As previously stated, the legislation would increase the borrowing costs for a home borrower by approximately $500 per $100,000 of mortgage. This is a new hidden tax on home buyers to pay for the new tax deductions granted to corporate good will. The Coalition believes that if Congress wishes to provide such a tax break for corporations that they should not do so on the backs of homeowners, but instead spread it across the entire tax base.

The rationale given for the intangible tax simplification legislation is that it will eliminate legal battles and problems in allocating asset value for the purchase of a business entity. Neither of these problems currently exist for mortgage servicing rights. First of all, these assets are bought and sold independently. The assets are

traded on their own. Secondarily, these assets are amortized over the actual life of the loan, and there are no outstanding problems with the IRS regarding the current method of amortization. This legislation would not eliminate any problems for the IRS, but indeed as we have shown, would increase the borrowing costs for homebuyers.

The Home Finance Coalition is aware that the Joint Committee on Taxation has estimated that including mortgage servicing rights within the proposed 14 year amortization schedule will increase tax revenue by a billion dollars over a five year period. We believe this number to be high, but in any event, we believe that it will be substantially reduced if not totally eliminated for two reasons.

First, any increased tax payment by mortgage servicers will be offset by a like amount of decreased tax payment by homeowners. It is true that the legislation would increase tax revenue for intangibles, since the mortgage servicer would pay more in taxes. However, increased dollars received from the mortgage servicers would be lost as the homebuyers increase their tax deductions due to the increased points that they will have to pay for home finance. In other words, whatever is gained from the mortgage servicers' from the intangible legislation will be lost in the deduct ions for points which a homebuyer is allowed to take on his tax return.

For example, let's assume the billion dollar number used by the Joint Committee. While overall tax revenue would increase by $1 billion from mortgage servicers, homeowners would be allowed increased deductions of $1 billion. No new net revenue would be generated. There may be some gain by the differential in the corporate tax rate versus the individual tax rate. However, individuals often are allowed to deduct mortgage points in full in the year of origination, as opposed to amortizing them over the life of the loan. Thus, we believe that the net effect will be a wash and there will be no new revenue for Treasury.

Should there be any additional revenue, this revenue will also be decreased should the mortgage servicer choose not to hold the servicing for the 7 or 8 years, but instead sell it during that period of time. When the servicing is resold, the seller is allowed to make up whatever amortization deduction loss he has had. Therefore, projected revenue would be diminished upon resale of the mortgage servicing.

Lastly, we would like to point out that the legislation as currently drafted would immediately reduce the value of mortgage servicing rights held by mortgage servicers and would not be prospective in nature. While it is true that as long as a servicer holds the servicing he currently owns, he could use the old amortization period, if he were to sell that servicing to a new buyer, the new buyer would have to use the new 14 year amortization. The net effect is that the market value will immediately decrease for mortgage servicing rights. Since banks and thrifts by statute must use a market value calculation of servicing rights for regulatory capital purposes, the immediate effect would be to reduce by approximately a billion dollars the regulatory capital of banks and thrifts. At the very least, any future legislation should allow servicing originated prior to the date of the legislation to be amortized under the old rules even if it is sold.

In conclusion, the Home Finance Coalition believes that the inclusion of mortgage servicing rights in the Intangibles legislation will increase borrowing costs for homebuyers by approximately $500 per $100,000 of mortgage. In addition, as we have outlined, little, if any, new net tax revenue will be generated. This asset is traded on a stand alone basis, and there are no outstanding issues with the Internal Revenue Service, nor are there any problems in allocating the value of this asset. The current system is working well. Therefore, the Coalition would respectfully request that mortgage servicing rights be granted the same exemption given to other financial instruments such as a futures contract, a foreign currency contract, a notational principle contract, an interest rate swap, or other similar financial contracts. It would be good economic' and public policy.

ATTACHMENT A.—PURCHASED MORTGAGE SERVICING RIGHTS

This chart assumes a PMSR is purchased for $1,680.00. It compares a straight line 7 year amortization with the proposed 14 year amortization and calculates the loss resulting from the 14 year amortization.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Current/7 Year Amortization	$240	$240	$240	$240	$240	$240	$240
Proposed/14 Year Amortization	$120	$120	$120	$120	$120	$120	$120
Difference	$120	$120	$120	$120	$120	$120	$120

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Tax Rate	40%	40%	40%	40%	40%	40%	40%
After Tax Difference	$48	$48	$48	$48	$48	$48	$48

Present Value of $120 X 7 X 15% Discount Rate = $500.00
PMSR Current Value $1,600.00
Less 14 Yr. Amortization $500.00
PMSR 14 Yr. Value $1,100.00
PMSR Value Loss in percent −29.7%.
New Tax on Homeowner $500.00

Prepared Statement of Floyd Williams

I. INTRODUCTION

Mr. Chairman and Members of the Committee, my name is Floyd Williams and I am Chief Tax Counsel of the Tax Foundation. It is indeed an honor for me to be here today to present testimony on the issue of simplifying the tax treatment of intangible assets acquired in business purchases. The proper Federal income tax treatment of intangible assets is a complex issue, which has generated a multitude of taxpayer controversies, and which deserves your full attention.

The Tax Foundation is a nonprofit, nonpartisan research and public education organization that has been monitoring tax and fiscal policy at all levels of government since 1937. We have approximately 600 members, consisting of large and small corporations, charitable foundations, and individuals. Our business membership covers practically every industry category. Because our membership often has many disparate interests on any given tax issue, I am not here today to represent any particular industry group nor am I here to speak for "Corporate America" in general. Rather, I would hope to strike a blow for good tax policy and tax simplification.

Over its more than 50 years of existence, the Tax Foundation has committed itself to principles that guide its research and public information agenda and that we believe should be the touchstones for all tax legislation. Among these principles, are the following:

- A good tax system requires that taxpayers be informed. They must know what is being taxed and how tax legislation is enacted.
- The tax system should be as simple as possible. Complexity makes accurate tax compliance needlessly expensive and punitive.
- Tax law should not be continually rewritten. Frequent change lessens citizen understanding of the Tax Code and complicates long-range financial planning.
- Changes in tax law should not be retroactive. Taxpayers must have confidence in the law as it exists when entering into a transaction.
- The tax law should not try to micromanage the economy with subsidies and penalties. The tax system should aim for neutrality in economic decision making, favoring neither consumption nor savings and investment.
- The U.S. tax system must be competitive with those of other industrialized nations. It should not impede the free flow of goods, services, and capital.

We believe that the efforts made thus far by the Congress to simplify, and bring more rationality to, the tax treatment of intangible assets are clearly a step in the right direction for Federal tax policy. The balance of my statement briefly summarizes some of the key points of present law on this issue, discusses the scope of the problems in this area as determined by the General Accounting Office, summarizes the provisions of H.R. 4210 relating to the amortization of intangible assets, and sets forth our general conclusions.

II. PRESENT LAW TREATMENT OF INTANGIBLE ASSETS

Present law generally allows taxpayers to claim depreciation deductions for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or that is held for the production of income (Internal Revenue Code section 167). However, under regulations issued by the Treasury Department (Treas. Reg. sec. 1.167(a)–3), depreciation deductions are not allowed with respect to intangible property unless such property has a limited useful life that may be determined with reasonable accuracy. The same regulations provide that no depreciation deductions are allowed with respect to goodwill or going concern value.

Accordingly, for depreciation or amortization deductions to be allowed with respect to intangible property, a taxpayer generally has to establish that the property can be distinguished from goodwill and that the property has a limited useful life

that can be determined with reasonable accuracy. This determination, which is basically dependent upon all the facts and circumstances of each particular case, has been addressed by numerous court decisions and Internal Revenue Service pronouncements.

Because of the facts and circumstances nature of the issue, it is not unusual that different results have been reached in different cases with respect to the same or similar types of intangible property. An illustration of this problem is evident in comparing the decision in *Donrey, Inc.* v. *United States,* 809 F.2d 534 (8th Cir. 1987), with the holding in *Newark Morning Ledger Co.* v. *United States,* No. 90-5637 (3rd Cir. 1991), rev'g 734 F. Supp. 176 (D.N.J. 1990), *cert. granted* April 6, 1992. In *Donrey,* the Eighth Circuit Court of Appeals held that a subscription list that was acquired in connection with the purchase of assets of a newspaper publishing company was amortizable if the taxpayer established a value for the subscription list that was separate and distinct from goodwill and the taxpayer established a useful life for the subscription list. In contrast, in the *Newark Morning Ledger* case, the Third Circuit Court of Appeals, which reversed the district court, held that subscription lists acquired in connection with the acquisition of the assets of a newspaper publishing company were not depreciable.

The U.S. Supreme Court recently granted certiorari in the *Newark Morning Ledger* case, in order to decide the issue of whether the purchaser of a newspaper business may treat the future revenues that it anticipates receiving from the continuing patronage of existing customers as an "intangible asset" that is depreciable under Code sec. 167. In the United States' brief on the petition for a writ of certiorari in the *Newark Morning Ledger* case, it was noted that "this case involves a recurring issue of substantial administrative importance that has given rise to inconsistent reasoning and inconsistent decisions among the circuits."

One of the major Internal Revenue Service pronouncements on the issue of customer-based intangibles is Rev. Rul. 74-456, 1974-2 C.B. 65, which reconsidered the IRS position in two prior rulings and removed the implication that customer and subscription lists, location contracts, insurance expirations, etc., are, as a matter of law, indistinguishable from goodwill possessing no determinable useful life. That ruling noted, further, that the depreciability of these types of assets is a factual question, the determination of which rests on whether the taxpayer establishes that the assets (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy. This ruling basically followed the holding in *Houston Chronicle Publishing Co.* v. *United States,* 481 F. 2d 1240 (5th Cir. 1973).

More recently, on January 30, 1990, the IRS issued an Industry Specialization Program coordinated issue paper addressing the depreciation of customer-based intangibles. That issue paper concluded that where an ongoing business is acquired with the expectation of continued patronage of the seller's customers such that the purchaser merely steps in the shoes of the seller, the two-prong factual test announced in *Houston Chronicle* and followed in Rev. Rul. 74-456 cannot be met. Accordingly, it is the current position of the IRS that if the customer-based intangible represents the customer structures of the acquired business, and that business possesses characteristics of goodwill, then the intangible is inseparable from goodwill, and, thus, nonamortizable as a matter of law.

The issue of the proper tax treatment of workforce-based intangibles has not yet been the subject of litigation to as great an extent as has customer-based intangibles. An IRS Industry Specialization Program coordinated issue paper, also released on January 30, 1990, stated the Service position that any value associated with having a trained staff of employees in place represents the going concern value of an acquired business. Thus, according to the IRS, the portion of the purchase price of an acquired trade or business that is allocable to the trained work force cannot be amortized. This IRS position was followed by the Tax Court in *Ithaca Industries. Inc.,* v. *Commissioner,* 97 T.C. No.16 (August 12, 1991), which held that the assembled workforce of the taxpayer's trade or business was not a wasting asset separate and distinct from going concern value.

In general, depreciation or amortization deductions have not been allowed with respect to renewable rights that are granted by a governmental entity since a useful life for such rights is not determinable with reasonable accuracy.

Likewise, many cases have held that the costs of acquiring a franchise, trademark, or trade name was not depreciable or amortizable because the taxpayer could establish neither that the franchise, trademark, or trade name was distinguishable from goodwill nor that such property had a limited useful life that was determinable with reasonable accuracy. However, Code section 1253 provides special rules regarding payments made on account of the transfer of a franchise, trademark, or trade name. In general, the acquirer of such property may amortize the cost of its acquisi-

tion over its useful life if a useful life can be established with reasonable accuracy. Moreover, even if a useful life cannot be established, a taxpayer may elect, under certain circumstances, to amortize the cost of acquiring a franchise, trademark, or trade name over a period of 25 years. A 10-year period is provided for certain small transactions.

In general, covenants not to compete are depreciable or amortizable only if they are distinguishable from goodwill and have useful lives that are determinable with reasonable accuracy. The IRS and taxpayers often dispute the issues of whether a covenant not to compete is depreciable, and what portion of the purchase price of an acquired trade or business is allocable to a covenant not to compete.

Pursuant to Treasury Department regulations, patents and copyrights are types of intangible property with respect to which depreciation deductions are allowed (Treas. Reg. sec. 1.167(a)-3).

Certain contract rights that are acquired in connection with the acquisition of a trade or business may be amortized if the buyer can establish both that the contract has a limited useful life, the duration of which can be established with reasonable accuracy, and the contract has an ascertainable value that is separate and distinct from goodwill.

Present-law allocation rules generally require that upon the acquisition of a business, the purchase price must be allocated first to cash and certain cash equivalents, second to marketable securities and certain other similar items, third to all assets, whether tangible or intangible, not in another category, and, fourth to nondepreciable goodwill or going concern value (Code section 1060). Any excess purchase price over the identified fair market value of depreciable assets must be allocated entirely to nondepreciable goodwill or going concern value. In general, however, present law does not provide statutory limits on the extent to which the purchase price may be allocated to amortizable assets rather than to nonamortizable goodwill or going concern value. Nor does present law specify a method for allocating purchase price among amortizable assets.

III. SCOPE OF THE PROBLEM AND NEED FOR RESOLUTION

The United States General Accounting Office last year issued an excellent report, titled "Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets" (GAO/GGD-91-88), which gives some idea of the scope of the problems with regard to the present-law treatment of intangible assets.

The GAO independently evaluated responses to a 1989 internal IRS survey regarding amortization of intangible assets. That survey asked IRS offices nationwide to provide information as of mid-1989 on all unresolved, or open, audit cases in their examination, appeals, or litigation units. These cases generally included tax returns for tax years 1979 through 1987. This data reflects only a portion of the purchased intangible asset Universe since it does not include unaudited tax returns, closed cases, or post-1987 issues.

Based upon the data it examined, the GAO estimated that from 1979 to 1987, taxpayers in nine major industry groups claimed deductions for 175 types of purchased intangible assets, identified as distinct from goodwill, and valued at $123.5 billion. The GAO found that in 70 percent of the survey issues in which taxpayers claimed that intangible assets had determinable useful lives, the IRS claimed that the intangible assets were equivalent to goodwill. In the remaining 30 percent of the issues, the IRS challenged the taxpayers' determination of value or useful life. The total adjustments proposed by IRS for these cases was over $8 billion.

GAO found that, by far, the largest category of intangibles in its survey was customer/market-based intangible assets. These included assets related to the customer structure or market factors of a business, such as core deposits, underdeveloped markets, and customer and subscription lists. Taxpayers in seven of the nine major industry groups allocated approximately $10.5 billion to customer/market based intangibles, nearly three times the amount that was allocated to the next largest category of intangibles (i.e., contract-based intangible assets).

The GAO concluded that disagreements between the IRS and taxpayers over which intangible assets may be amortized will continue unless changes are made in the current rules.

IV. PROVISIONS OF H.R. 4210 RELATING TO AMORTIZATION OF GOODWILL AND OTHER INTANGIBLES

H.R. 4210, the "Tax Fairness and Economic Growth Act of 1992," as reported by the conference committee (Report 102-461, 102D Congress, 2d Session), and passed by the House and Senate, but vetoed by the President, would have allowed an amortization deduction for the capitalized costs of certain intangible property that is ac-

quired by a taxpayer and held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of this amortization deduction would have been determined by amortizing the adjusted basis of the intangible asset ratably over a 14-year period beginning with the month in which the asset was acquired. The amortization deduction generally would not have applied to an intangible asset that was created by the taxpayer unless such asset was created in connection with a transaction involving the acquisition of a trade or business (or a substantial portion thereof).

In general, intangible assets that would have qualified for the amortization deduction would have been those included in one or more of the following categories:

(1) goodwill and going concern value;

(2) intangible property relating to workforce, information base, know-how, customers, suppliers, or other similar items;

(3) licenses, permits, or other rights granted by a governmental unit (or an agency or instrumentality thereof);

(4) covenants not to compete (or arrangements having substantially the same effect) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or substantial portion thereof); and

(5) franchises, trademarks, or trade names.

In contrast, certain types of property would have been specifically excluded from qualification for the amortization deduction provided by H.R. 4210. Those were:

(1) interests in a corporation, partnership, trust, or estate;

(2) interests under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial arrangement;

(3) interests in land;

(4) certain computer software (computer software that (a) is readily available for purchase by the general public; (b) is subject to a non-exclusive license; and (c) has not been substantially modified would have been amortizable over a 36-month period.);

(5) certain interests in films, sound recordings, video tapes, books, or other similar property;

(6) certain rights to receive tangible property or services;

(7) certain interests in patents or copyrights;

(8) interests under existing leases of tangible property;

(9) interests under existing indebtedness (except for the deposit base and similar items of financial institutions); and

(10) franchises to engage in professional sports (along with any items acquired in connection with such franchises).

The provisions of H.R. 4210 relating to the amortization of intangible assets generally would have applied to property acquired after the date of enactment of the bill. However, taxpayers could have elected to apply the provisions either to (1) all property acquired after July 25, 1991, or (2) all property acquired in certain taxable years for which the statute of limitations had not expired. Furthermore, a taxpayer could have elected to apply present law to property acquired after the date of enactment pursuant to a binding written contract in effect on February 14, 1992. Finally, special rules would have applied to prevent taxpayers from converting existing goodwill, going concern value, or other intangible assets for which depreciation or amortization deductions would not have been allowable under present law into amortizable property to which the bill applied (so-called "anti-churning" rules).

In general, a taxpayer who elected to apply the provisions of H.R. 4210 to open years for intangible assets acquired prior to July 25, 1991, would have been permitted to amortize such assets over a 17-year period (rather than under the bill's general 14-year period).

V. CONCLUSIONS

Enactment of legislation similar to that contained in H.R. 4210, which would allow an amortization deduction for the cost of intangible property, including goodwill and going concern value, that is acquired in the purchase of a business would have a salutary effect upon the tax law.

The current law tax treatment of purchased intangible assets has been, and left unchanged, will continue to be, the source of considerable controversy between taxpayers and the Internal Revenue Service. Among other things, these controversies revolve around such issues as whether an amortizable intangible asset exists, the portion of the purchase price of a business that is allocable to amortizable intangible

assets, and the proper methods and periods for recovering costs of amortizable intangible assets.

The number of these disputes between taxpayers and the IRS increased significantly during the 1980s with that decade's increase in business acquisition activity. The facts and circumstances nature of the controversy continues to lead to costly disputes between taxpayers and the IRS and often results in inconsistent treatment for similarly situated taxpayers. Most likely, a continuation of current law will mean more of the same with the courts being the final arbiters in those cases where taxpayers can afford to pursue the matter through the judicial system.

The disparity between the treatment of goodwill, which is not amortizable, and other intangible assets that are amortizable provides incentives for taxpayers to establish values and lives for purchased intangible assets other than goodwill, thus, leading to disputes with the IRS. Allowing amortization deductions for purchased goodwill and going concern value would eliminate that incentive.

A major tenet of U.S. tax policy is that income should be matched, to the extent possible, with expenses incurred in order to reach a reasonable determination of net income. The denial of amortization deductions results in an inaccurate determination of taxable income because expenses are not properly matched to the income generated. Allowing cost recovery for these assets provides a more accurate measurement of income. Moreover, the development of guidelines for the amortization of purchased intangibles would help to eliminate conflicts over whether or not an asset can be amortized and, if so, over what useful life, and would provide consistent treatment for all taxpayers.

In short, many of the controversies of present law could be eliminated' through the specification of a single method and period for recovering the cost of most acquired intangible assets, and by treating acquired goodwill and going concern value as amortizable intangible assets. This would be a significant step toward meeting the goal of proper and consistent administration of our nation's revenue laws, and would eliminate the continuing uncertainty and uneven treatment of taxpayers that exist in this area of the law.

Quite significantly, enactment of legislation along the lines of that contained in H.R. 4210 would eliminate most of the costs that currently are being borne by taxpayers and the government to resolve controversies over the proper tax treatment of purchased intangible assets. These costs could then be devoted to more productive endeavors. Moreover, those taxpayers who currently cannot afford the costs of pursuing a controversy through the IRS administrative process or challenging the IRS in the courts would be treated much more fairly.

Finally, I would like to point out that by simplifying the tax treatment of intangible assets acquired in business purchases, the Congress would be recognizing one of the major principles of the Tax Foundation, which is that the tax system should be as simple as possible. Present law in this area serves as a graphic example of how complexity can make accurate tax compliance needlessly expensive and punitive. Moreover, this is an area of the law where meaningful simplification is within reach. Although, as with any tax legislation, there would be winners and losers, in this case, most taxpayers would welcome the certainty and the reduction in IRS audit and legal expenses that would flow from major simplification in this area of the tax law.

COMMUNICATIONS

STATEMENT OF THE AIR TRANSPORT ASSOCIATION OF AMERICA

The Air Transport Association (ATA), is the Washington, D.C.-based trade association representing the nation's scheduled airlines. Its member airlines comprise approximately 97 percent of the nation's commercial air travel. The ATA, on behalf of its members, appreciates this opportunity to express the airline industry's views on the issue of the tax treatment of purchased intangible assets, particularly as they relate to simplification of the treatment of intangibles as found in Section 4501 of H.R. 4210, and its accompanying legislative history.

The airline industry, like many other industries, favors the Internal Revenue Code changes proposed in H.R. 4210 on the subject of amortizing the acquisition costs of intangible assets, because they promote simplification, certainty, predictability, and ease of administration and audit. The proper tax treatment of the amortization of intangibles is an area of the Code where taxpayers and the Service are frequently in disagreement and spend much time, effort, and money to resolve highly technical disputes. These controversies arise in the airline industry as well, since a large quantity of the assets purchased by airlines are intangible assets, such as international route certificates and slots and airport gates. The uncertainty about the proper tax treatment of these purchased intangibles often results in expensive litigation.

Section 4501 of H.R. 4210 and its legislative history proposed to simplify the tax treatment of intangibles and would have provided the desired certainty to the airlines while eliminating controversy, costly appraisals, and litigation. New section 197, and its legislative history, for example, would have provided an amortization life of 14 years for the acquisition costs of airline routes and slots.

This new provision of the Code and its accompanying legislative history would also have confirmed that the acquisition costs of airport gates were to be amortized over their remaining lease terms, as under current law. This confirmation of current law was expressly designed and intended to provide guidance to the IRS and taxpayers for resolving existing disputes. Establishing a simple rule for the amortization of the acquisition costs of these purchased intangible assets would furnish the certainty and predictability in the proper tax treatment for these unique assets that is currently missing.

Permitting the amortization of these purchased assets is also consistent with the concept of matching expenses with the income resulting from the assets, which is the tax policy basis for all depreciation and amortization expenses. The sale of slots and routes results in income to the seller which is taxable gain to the extent the sales price exceeds the basis of the asset. If the selling airline was originally granted this slot or route authority by the government, the basis of the asset may be virtually zero, and thus the entire sale price would result in a taxable gain to the seller—but without the ability to amortize the acquisition costs, there would be no matching expense item for the buyer.

The reason for the granting of these rights initially by the government was to control the provision of services in the public's best interest. The transfer of routes, for example, to a financially stronger airline is subject to Department of Transportation and Department of Justice approval, the result of which provides improved service to the public. Section 2510 of H.R. 4210 would have further served the public interest by providing for simplicity and eliminating unnecessary litigation.

For all the above reasons, we believe that the Section 4501 of H.R. 4210, and its important clarifying legislative history, provides a fair and balanced approach to the amortization of the acquisition costs of purchased intangibles, and promotes administrative ease and simplification. The airline industry fully supports these provisions.

Statement of the American Bankers Association

The American Bankers Association (ABA) is the national trade and professional organization for America's commercial banks. The members range in size from the smallest to the largest banks, with 85 percent of our members having assets of less than $100 million. Assets of our members comprise over 90 percent of the total assets of the commercial banking industry.

The banking industry is deeply interested in the tax treatment of purchased intangible assets because significant forces of change and consolidation within the banking industry make acquisitions of financial assets, including intangible assets, much more likely. Increased competition from non-bank providers of financial services has created pressures to take advantage of economies of scale to cut expenses and raise capital, and in some cases merge. Changes in state laws over the last ten years permit interstate acquisitions within regions, resulting in purchases that were previously prohibited. Legislation to permit full interstate banking and branching, as was passed by both Houses of Congress in 1991 but not enacted into law, would accelerate the pace of change and consolidation. The FDIC and RTC are selling off whole institutions as well as assets of failing or failed institutions. All of these activities result in the purchase and sale of intangible assets.

Of course, many bank combinations will be stock acquisitions, such as the recent merger of Bank of America and Security Pacific; and therefore, will not involve writing up the tax basis of the assets. In taxable asset acquisitions, assumptions of failed institutions and even stock mergers, there could be ripple effect cash transactions such as the sales of duplicate branches, which result in further transfers of amortizable intangible assets.

The ABA strongly supports the enactment of simplification legislation such as Section 4501 of H.R. 4210, passed by Congress in March, which provides for amortization of purchased intangible assets, including goodwill and going concern value, over a statutory recovery period of 14 years. We regard the inclusion of goodwill/going concern value as a crucial element of the bill and would oppose any attempt to remove it from the legislation. We support the 14 year period as a basis for uniform treatment, and would oppose lengthening that period in order to offset the cost of changes to other provisions in the legislation. Mr. Chairman, the broad and deep support in our industry for the bill reflects the view that it is a major step towards simplification of the tax law, and will resolve an enormous source of controversies in IRS audits of banks. By providing tax certainty for purchasers of intangible assets, this legislation will provide for consistent treatment of similarly situated taxpayers, and contribute an element of certainty in the economic analysis necessary to evaluate proposed acquisitions.

Mr. Chairman, we must stress that our position on this bill was achieved after serious consideration of the trade-offs involved. There are significant pluses and minuses for the banking industry in the bill. Banks have been able to establish, under current tax law, more favorable recovery periods based on the real economic lives of the intangible assets acquired. Bank taxpayers have sustained recovery periods as short as seven to ten years. Moreover, intangible assets have been eligible for accelerated methods of depreciation, consistently upheld by the courts, in contrast to the straight line depreciation required by the provision.

The approach of the IRS, however, in these cases makes amortization of intangible assets fraught with uncertainties that hinder normal business decisions, and greatly complicate settlement of audits. The IRS litigating position, as reflected in the recent decision in the *Newark Morning Ledger*[1] case, is that customer based intangibles acquired as part of an on-going business can never be separated from goodwill. This extreme approach ignores recent case law, defies economic reality, and fails to accurately match income and expenses.[2] Therefore, this decision highlights the need for this legislation with its 14 year straight-line amortization of all intangible assets, including goodwill. This is not a better tax answer than current law, but it is a better overall business result.

While banks acquire many types of intangible assets in the regular course of business, the example of deposit base intangibles best illustrates the need for enactment of the legislation.

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[1] *Newark Morning Ledger Co.* v. *U.S.*, *cert. granted* (U.S. No. 91–1135 4/6/92). ABA will file an *amicus curiae* brief in support of the taxpayer in the U.S. Supreme Court. The Third Circuit's position mischaracterized the case law on depreciation of intangible assets by adopting a *per se* legal standard rather than the well-accepted factual test.

[2] *See* General Accounting Office report *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets August 1991*, GAO/GGD–91–88, at page 5.

DEPOSIT BASE INTANGIBLES

Deposit base intangible refers to the asset that arises from the ability to use the low cost funds that exist in core deposit accounts at the date of acquisition of a bank. The price paid is based on the present value of the future cost savings (additional earnings) these acquired low cost funds will produce over the costs of more expensive sources of funds. The term core deposits generally refers to a mix of deposits that has a significant number of non-interest bearing or low interest bearing accounts. These include checking accounts, regular savings accounts and other savings accounts or vehicles that may have restrictions on the timing of withdrawals. Core deposits are a relatively low cost source of funds, reasonably stable over time and relatively insensitive to interest rate changes. These accounts do not remain with a bank indefinitely, but eventually close because depositors' circumstances change over time. The balances in the acquired accounts decline following a pattern that can be determined with reasonable accuracy.

The IRS routinely disallows all deductions claimed for deposit base intangible amortization as indistinguishable from goodwill as a matter of law. This position ignores current law under IRC Section 167 which is spelled out in Rev. Rul. 74–456. This ruling provides that:

> allowance for amortization of purchased intangible assets turns on a *two-prong factual inquiry:* (1) whether the intangible has an ascertainable value separate and distinct from any goodwill or going concern value obtained in the acquisition, and (2) whether it has a limited useful life which can be determined with reasonable accuracy.

Amortization of any intangible asset involves a rigorous factual determination. The rigors of the test are illustrated by the fact that some taxpayers have been unable to satisfy to the courts that they have met the burden of proof at the trial level. More recently, however, as the courts have better defined the standards necessary, a, number of banks have successfully met the burden of proof. In *Citizens and Southern Corporation and Subsidiaries* v. *Commissioner,* 91 T.C. 463(1988), *affirmed* in an unpublished opinion by the 11th Circuit, 900 F.2d. 266(1990), the Tax Court found that core deposits were amortizable even though they had been acquired in the purchase of a going concern. The court found that the core deposits had a separate value as a low cost source of funds. In a recent Tax Court memorandum decision, *Colorado National Bankshares Inc. v. Commissioner,* 60 T.C.M. (CCH) 771(1990), the court concluded that the "core deposit intangible at issue here has an ascertainable cost basis separate and distinct from the goodwill and going concern value of the acquired banks."

The IRS continues to litigate the legal question of whether deposit base intangibles can be separate and distinct from goodwill rather than deal with the facts and circumstances at audit. As a result, taxpayers must go to considerable expense hiring consultants to value the intangibles and to provide the statistical and financial analysis necessary to meet the burden of proof after *Citizens & Southern* and *Colorado National.* The prospect that the IRS examination agents will deny deductions for intangible assets, and the uncertainty regarding the results at either the appeals or litigation level, effectively require bank taxpayers to set aside reserves in their financial statements for the contingency that some additional taxes and interest will be paid in the future. A change in the law to provide for amortization of all intangible assets will eliminate the IRS legal semantics and uncertainties of litigation, thereby allowing taxpayers to price acquisitions on the basis of the real economics of the deal.

Having indicated our support for the bill, we would like to comment on two specific aspects of the bill, the details of which are very important to affected taxpayers.

MORTGAGE SERVICING RIGHTS

Mortgage servicing rights refers to the asset that arises from the right to service a portfolio of loans owned by others. The right entitles the servicer to a future stream of income which is based on a percentage of the outstanding principal of the mortgages being serviced.

Purchases of mortgage servicing are an important part of the mortgage banking business. The amortization of purchased servicing rights has not been a source of controversy between the IRS and bank taxpayers. Mortgage servicing rights have long been depreciated over shorter lives than provided in this legislation, and by accelerated methods of depreciation which better reflect their real economic life. If mortgage servicing rights are treated as Section 197 intangible assets, the marketplace will adjust to the new rules by reducing the prices paid to originators of the mortgages when the servicing is the only asset being sold.

We urge the Congress to exclude mortgage servicing from the legislation for the same reasons that the House and Senate excluded computer software which is readily available for sale and for films, sound recordings, video tapes, books and other similar property not acquired in a substantial portion of a trade or business. These exclusions are justified because there has not been any controversies about their useful life and requiring them to use a 14 year straight line depreciation scheme will only reduce the value of these assets in the hands of the taxpayer that created them. Similarly, there is no tax policy rationale for imposing the simplification provisions of the legislation on the sale of mortgage servicing rights.

The well developed secondary market for mortgages and mortgage servicing has been encouraged by the government, in particular through the operations of Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, in order to stimulate home financing. Financial institutions are encouraged to originate mortgage loans and to sell them into the secondary market so that they can be prepared again to offer new mortgage loans. This mechanism of home financing would be burdened to the extent that originators of home mortgages would receive lower proceeds from having to sell their mortgages and mortgage servicing rights to purchasers which would have to use the longer 14-year amortization schedule. While it would be difficult to quantify the impact that this change in the tax law would have on the cost of mortgage financing, any impact would clearly be to the detriment of the home buyer. Since simplification is not needed in this area, we urge the Congress to follow the principle "if it ain't broke, don't fix it." We believe Congress should exclude mortgage servicing from the provisions of the intangible simplification legislation just as computer software and films and recordings were excluded in the conference version of the bill.

RETROACTIVITY/EFFECTIVE DATE

In general, the legislation would be effective prospectively, applying to intangible assets acquired after the date of enactment. The taxpayer may elect to apply this provision to all acquisitions after July 25, 1991 and indeed many taxpayers have relied on the legislative language using this date. Moreover, there is another provision which provides elective retroactivity (with a 17 year write off) to all open years as a way to resolve unnecessary controversies which now burden both taxpayers and the IRS.

We do not believe it is possible to efficiently resolve the enormous number of cases pending in various stages of audit and pre-litigation by means of legislative history in connection with this legislation. Common sense would suggest that if the legislation is enacted, the IRS would recognize that there is no precedential value to continuing to litigate questions such as whether core deposits are indistinguishable from goodwill. Nonetheless, based on our experience, we believe that the IRS would continue to argue that a substantial portion of the purchase price in acquisitions prior to enactment should be allocable to nondepreciable goodwill, rather than allocating that cost to the amortizable intangible asset such as core deposits. The only way to break the Gordian knot which now binds taxpayers faced with existing cases involving amortization of intangible assets is to permit the amortization of goodwill. This will prevent the IRS from continuing to play games on the allocation of purchase price.

The IRS has created an enormous tax administration backlog by holding up normal audit settlements on customer-based intangible asset cases. The affected taxpayers deserve the option of fair and speedy resolution offered by the election to retroactively apply this language to all open years. This option, however, should not be forced on those taxpayers which acquired intangible assets, priced under existing law, where the taxpayer is prepared to substantiate its tax filing position and litigate, if necessary.

Based on the circumstances in the banking industry, elective retroactivity is not necessarily a revenue loser for the Treasury. The taxpayer must elect to have the seventeen year amortization apply to all acquisitions of intangible assets in all open years, and cannot cherrypick the acquisitions with beneficial results. This mirrors the blanket coverage of prospective application of the bill. We believe that many corporate taxpayers would find it attractive to elect retroactive application of the bill, even if it means giving up a shorter amortization schedule and paying tax now to the IRS based on reduced amortization deductions. The cost of the cash outlay for this tax could be offset, in the eyes of corporate management, by the financial statement benefit from releasing the tax contingency reserve for the uncertainties of tax audit and litigation. This could be a win-win situation—the IRS gets tax revenue now and corporate balance sheets reflect a healthier condition. We are not surprised

at this possible result. It merely parallels how we believe the bill will work in future tax years.

Frankly, Mr. Chairman, the effective date issue on which all of our members are in agreement is that the bill should be enacted as quickly as possible.

CONCLUSION

The ABA supports this simplification legislation even though it will provide a longer amortization period for many intangible assets acquired by banks. The cost to the bank taxpayer of the longer amortization period is more than offset by providing certainty of the result and by reducing the costs of litigation for the bank (and the IRS). Given the prospect of increasing intangible asset acquisitions by banks in coming years, the ABA supports the bill because future bank asset acquisition bids will be more precise, based on true economic values.

Thank you for your consideration of our views.

STATEMENT OF THE AMERICAN TEXTILE MANUFACTURERS INSTITUTE

Pursuant to your committee's request for public comments, the American Textile Manufacturers Institute (ATMI) would like to submit for the record our views on the tax treatment of intangible assets. ATMI is the national trade association for the domestic textile industry. Our member companies operate in more than 30 states and account for approximately 75 percent of all textile fibers consumed by mills in the U.S.

First of all, ATMI agrees with the objective behind proposals such as H.R. 3035, which was originally introduced by House Ways and Means Committee Chairman Rostenkowski. Indeed, we support tax simplification and feel it is desirable for intangible property to be amortized under reasonable rules which are both fair and simple.

However, Section 4501 of H.R. 4210 (the tax bill recently vetoed by the President) proposes one amortization schedule of 14 years for most types of intangible property, with the exception of certain software and other intangible property. ATMI's Board of Directors recently discussed this matter and approved a resolution opposing the provisions contained in H.R. 4210 unless they were modified to permit the write-off of intangible assets which have a definite fixed life other than the proposed 14 years. Our Board, in recognition of the pay-as-you-go requirements of the 1990 budget agreement, recommends that the revenue effect of such a change be offset by lengthening the write-off period to more than 14 years for all remaining intangible assets subject to amortization under the proposed legislation. If this were not possible, a modification providing individual class lives for various types of intangible assets would be acceptable.

We offer these recommendations to you for the Committee's use during consideration of this important issue.

STATEMENT OF BELLSOUTH

BellSouth is pleased to submit this writttetr statement for the record of the April 28, 1992 Senate Finance Committee hearing on simplifying the tax treatment of intangible assets acquired in business purchases.

Through its subsidiaries, BellSouth provides local exchange telecommunications services in nine Southeastern states and a variety of other services related to telecommunications across the United States and overseas. The tax treatment of intangible assets is a significant issue to BellSouth because of the importance of intangible assets in its provision of telecommunications services. Bellsouth believes that simplification is essential to eliminate current problems in resolving IRS disputes regarding the treatment of intangible assets and to enable management to make informed business decisions.

BellSouth is a member of the United States Telephone Association ("USTA") and participated in the drafting of USTA's written statement for this hearing which urges the prompt passage this year of simplifying legislation in the form of section 4501 of the "Tax Fairness and Economic Growth Act of 1992" (H.R. 4210) as vetoed by the President this year. BellSouth fully supports this position.

BellSouth urges the Senate Finance Committee and Congress to address the simplification of intangibles and not wait for the Supreme Court to hear and decide *Newark Morning Ledger Co.* v. *U.S.*, 945 F2d 555 (3rd Cir. 1991), *cert granted* 60 USLW 3687 (April 6, 1992). That case involves only one type of intangible asset, subscription lists, and the Supreme Court is unlikely to provide meaningful sim-

plifying guidance on the tax treatment of acquired intangibles generally. It also appears to us that the outcome of intangibles amortization cases has depended as much on the sophistication of the taxpayer's proof, which in turn is largely dependent upon the taxpayer's appetite for legal and appraisal fees, as the legal principles involved.

BellSouth supports the simplification approach taken in section 4501 of H.R. 4210 whereby all general "section 197" intangible assets, including goodwill, are amortizable over a uniform 14 year period. BellSouth believes that this approach will eliminate current controversies regarding identification of intangible assets separate from goodwill, the valuation of intangible assets, and the life and rate of amortization of intangible assets. BellSouth further believes this simplification effort only will be effective if government granted licenses and franchises are included in the definition of "section 197" assets, as was provided in section 4501 of H.R. 4210.

BellSouth also believes that separately purchased software, which currently is subject to expensing or amortization over a useful life not to exceed 5 years under Revenue Procedure 69–21, should remain subject to tax treatment which reflects its economic life. This is necessary for national competitiveness, and there is no simplification reason to lump software with general "section 197" intangible assets to be treated in the same manner as goodwill. BellSouth believes that three year amortization for all software other than specialized software acquired as part of a business acquisition as provided in section 4501 of H.R. 4210 is a reasonable compromise.

BellSouth has several comments with regard to the effective date of intangibles simplification legislation. First, although BellSouth supports the concept of elective retroactive application of the simplification rules as generally provided in section 4501(g) of H.R. 4210 because of the potential to resolve controversies arising through the audit of past years, it urges the Senate Finance Committee and Congress not to allow debate over retroactivity to derail enactment of the substantive provisions of section 4501 of H.R. 4210. BellSouth believes that such a bill applied on a prospective basis is better than no bill.

Second, BellSouth urges that the change in the amortization of software be made effective on the first day of a taxpayer's fiscal year following enactment either as a general rule or at the election of the taxpayer. Unlike "section 197" intangible assets acquired as part of the purchase of a trade or business, software in many cases is acquired in large numbers of separate purchases as part of routine operations. It accordingly would be administratively difficult and expensive to apply a mid-period effective date to software amortization. For this same reason, and because the tax treatment of software has been well established since Revenue Procedure 69–21, BellSouth urges that software be excluded from any retroactivity rule that might apply to "section 197" intangible assets.

Finally, as additional specific comments on the retroactivity rules in section 4501(g) of H.R. 4210, BellSouth believes that the section 4501(g)(2) election applicable to intangible assets acquired after July 25, 1991 and before enactment should be retained and applied to "section 197" intangible assets in order to conform to the sense of the House of Representatives resolution H. Res. 292, November 26, 1991. BellSouth also believes that the section 4501(g)(3) retroactivity rules could be made more equitable and usable by taxpayers by allowing taxpayers to net tax overpayments against tax underpayments arising from the retroactive application of section 4501 and by not requiring taxpayers to apply the new rules back to a year for which a controversy may not exist. At a minimum, taxpayers should only be required to apply a retroactive election to years which are still open on the date of enactment.

In conclusion, BellSouth joins USTA in supporting the prompt passage of a bill this year simplifying the tax treatment of intangibles in the form of section 4501 of H.R. 4210.

STATEMENT OF BRIAN M. FREEMAN ENTERPRISES, INC.

I would like to add my limited comments for consideration in the record concerning H.R. 3035, which would increase the allowability of amortization of intangibles. My points are not profound, but merely an attempt to cut through the confusion produced by the advocacy present. They have been requested by one of my union clients; but, as you will see, my views are independent.

The amortization of intangibles is a very complex issue, for which there is no clearly correct answer. The existing system and the IRS administrative approach to date have worked and produced a reasonable balance until recently. In fact, some of the criticism results from the IRS' introduction of flexibility in the administration of its initial historical approach; it would not have resulted if the IRS had main-

tained a firm and unambiguous position against the encroachment of the definition of intangibles and their valuation and amortization.

Depending upon one's perspective and Congress' intent, the criticisms are both and either correct and/or incorrect. Some change in the treatment may be necessary to end the controversy and the resources wasted in the ongoing dispute concerning amortization. However, it is not clear that the solution should be to increase the amortization; it is at last as arguable that the change should be to preclude all amortization.

In this context, the following approach appears to create a reasonable balance. It best limits the negative effects of change while dealing with the valid criticisms of the status quo.

1. For transactions which have occurred: The issue of equity and dispute avoidance can be addressed by allowing amortization for transactions which have occurred. This would also contribute to the viability and soundness of enterprises with existing capital structures in place, even though it also may create some windfalls.

2. Prospectively: There should be no amortization of intangibles. A clear and unambiguous prohibition rule would eliminate the issue of equity, ongoing disputes and litigation. The issue of increased amortization should be addressed, if at all, only in the context of comprehensive treatment of the other tax elements relevant to the same and comparable types of corporate and other transactions (i.e., other tax issues on sales, acquisitions, and mergers) and as a part of broad based tax simplification.

In our view, there should be a relatively free market for corporate mergers and acquisitions. However, prohibiting amortization would be an acceptable result to avoid both the tax revenue costs and the problems of new transactions subsidized by the Government. The capital and financial markets are not valuing companies and their debt capacity assuming the greater, amortization; they are being discounted for the uncertainty and litigation present. What is being sought by increased amortization is largely an ex post facto opportunity for financial engineering. To the extent increased amortization were allowed, it would create windfall in facilitating higher prices for future transactions. Increased amortization would increase the number and pricing of transactions.

Admittedly, prohibition would reduce both transactional activity and prices. However, the 1980's demonstrate that excess activity is not necessarily positive; they suggest strong arguments that additional incentives should not be provided. In any event, it would be appropriate for congress to restrict the tax subsidy and, particularly, where a change in the status quo is sought.

3. When and if addressed, any increase in amortization should be targeted narrowly on the perceived problem and should not be excessively broad. For example, the benefit of the increase could be made unavailable to subsidize transactions which are excessively leveraged; i.e., where the tax benefits primarily allow an increase in price paid and do not inure to the benefit of ongoing operations. It could be targeted by adopting a limitation which prevented deductibility and triggers recapture whenever the ratio of debt to invested equity (ignoring the tax savings from deductibility) exceeded a specific level. Likewise, it could be made available only if reinvested in the business at levels above historical levels and/or industry average, and recaptured on a withdrawal. Similar rules could be developed to prevent perceived potential abuses and to achieve other goals.

Statement of the Coalition for Fair Treatment of Intangibles

GENERAL BACKGROUND

On July 25, 1991, Dan Rostenkowski, Chairman of the House Committee on Ways and Means, introduced H.R. 3035, a bill that Senator Daschle aptly described as "a bold proposal" to completely overhaul and simplify the tax treatment of intangible assets. Chairman Rostenkowski's statement accompanying the bill cited the need to reduce taxpayer-government controversies in this area and explained that the bill would be considered in the context of the Committee's tax simplification effort. The bill generally required the cost of most acquired intangible assets, including goodwill and going concern value, to be amortized ratably over a 14-year period.

H.R. 3035 as introduced would resolve many difficult and complex issues surrounding the proper tax treatment of intangibles. It contained the seeds of a much improved situation, for taxpayers and the government alike, both in terms of achieving a regime that improves the certainty of tax result and in terms of treating these very important assets in a manner which is more supportive of international competitiveness.

H.R. 4210, as adopted by the Conference Committee, resolved most of the concerns taxpayers raised regarding the original bill. The intangible simplification provisions adopted by the Conference Committee on H.R. 4210, as currently structured, have our full support and we urge their speedy adoption. The bill includes elections for retroactive application of the new rules to all open taxable years, and thus substantially reduces existing disputes by providing taxpayers an opportunity to "clear the decks" of the existing disputes. We recognize that the mechanism in H.R. 4210 to address existing controversies has been re-estimated by the Joint Committee on Taxation and determined to lose significant revenues. We support the Committee's efforts to pursue alternatives to clear up existing controversies in a revenue neutral manner.

What follows is a discussion of relevant provisions, in the order the bill is drafted, with remaining recommendations highlighted.

Joint Ventures and Associations—Proposed Section 197(c)(2) and (d)(1)(C)(iii)

Background. It is a common practice for businesses to join together to fund research, set industry standards, and perform a wide variety of other mutually beneficial services. The payments to such ventures (i.e. research consortia, joint ventures, and associations) are generally expensed. The intangible described as "know-how . . . or other similar item" in proposed Section 197(d)(1)(C)(iii) is broadly defined in H.R. 3035 and H.R. 4210, raising many concerns about its potential scope and application to this business situation.

Issue. Without a clear indication of the intended treatment, new controversies can arise as to whether these business arrangements are payments for "know-how" that must be amortized over 14 years as opposed to currently deductible business expenses.

Solution. The Conference Report for H.R. 4210, on page 555, resolves much of this concern in the explanation of what self-created intangibles are excluded from the scope of the new rules. It provides that "a Section 197 intangible that is owned by a taxpayer is to be considered created by the taxpayer if the intangible is produced for the taxpayer by another person under a contract with the taxpayer that is entered into prior to the production of the intangible." This exclusion might be interpreted as too narrow to apply to the case where a taxpayer's ownership interest is an indirect ownership through a taxpayer's interest in a joint venture.

In order to resolve any remaining ambiguity, it should be clarified further by providing in the Committee report that such intangibles are self-created if the taxpayer's ownership is through an ownership interest in a joint venture that contracts for production of the intangible.

Computer Software—Proposed Section 197(d)(1)(C)(iii)

Background. The current amortization rules for purchased software are well settled and contained in Revenue Procedure (Rev. Proc.) 69–21, published by the IRS in 1969. Purchased software is amortized over 5 years or such shorter period as appropriate. There is an exception for software purchased with hardware, where the invoice does not separately state the price of the software. Such software is depreciated with the hardware over 5 years on an accelerated basis.

Under Rev. Proc. 69–21, costs attributable to the development of software by the taxpayer are consistently treated like current expenses and deducted under rules similar to those under Code Section 174. These rules presumably would not be changed by H.R. 3035, although it is not entirely clear that the term "self-created" has the same meaning as the software treated as developed by the taxpayer in Rev. Proc. 69–21.

While H.R. 3035 as originally introduced did not explicitly address software, page 10 of the Chairman's explanation stated that " . . . a license of pre-existing software" is included within the scope of the term "know-how" in proposed Section 197(d)(1)(C)(iii). Software was also referenced as "know-how and similar items" on page 4 of the Chairman's explanation. Since the usual manner of obtaining software is a purchase of the license or right to use, there was a serious concern that purchases of software would have to be amortized over 14 years under the original bill.

Issues. Fourteen years would bear no semblance to actual useful life for this productive asset. In fact, industry experience indicates that software has a very short life—5 years or less. Such a lengthy amortization period in comparison to current practice exacts a penalty on those U.S. companies extensively using software in their operations. It also places them at a competitive disadvantage relative to international software purchasers. For example, Japan, France, Germany, and the United Kingdom allow recovery of the cost of software over peri-

ods from 3 to 5 years. An amortization period of 14 years would prove costly to U.S. companies, discourage software investment, and ultimately impair our international competitiveness.

Further, as a productive asset, software more closely resembles tangible assets deployed in business operations than other intangibles such as goodwill and going concern value. Like productive tangible assets, its value is typically ascertained from separate invoices, and it has a measurable useful life. Since software is clearly distinguishable from other intangibles with less definitive lives and values, the policy objectives of reducing the need for appraisals and providing a uniform predictable set of rules do not seem applicable to software.

Solution. H.R. 4210 provides a simplifying and very acceptable approach to this issue for most software users. Section 197(e)(3) excludes from the new 197 rules "computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified" as well as other software that is not acquired in the acquisition of a trade or business. The bill would add a new Section 167(f) to provide that software excluded from Section 197 and depreciable under Section 167 is deductible straight line over 36 months.

Covenants not to Compete—Proposed Section 197(d)(1)(F)

Background. The current rules for the amortization of non-compete agreements are well established by existing court doctrine. When a buyer and seller agree to an amount that will be paid for the non-compete agreement and that amount is supported by the relevant facts and economics of the situation, the amount may be amortized over the stated term of the agreement. From a business perspective, a non-compete agreement is an extremely important part of most merger and acquisition transactions. Many sellers are in a position to devastate the business they are selling through future competition. As a result, most buyers are unwilling to enter into transactions without a non-compete agreement with the seller. We recognize covenants not to compete are an area of frequent valuation dispute that the bill should properly address.

Inasmuch as the period of a non-compete agreement is set by contract, the period of the covenant has not been an issue subject to controversy. However, the allocation of value between the non-compete agreement and other assets (and in the case of a stock acquisition, the allocation between the non-compete agreement and the stock) is a frequent source of controversy.

H.R. 3035 as introduced, and H.R. 4210 as adopted by the Conference Committee, would provide for 14 year amortization of covenants acquired as part of a business acquisition. Fourteen years is considerably longer than the period most agree would be legally enforceable. In the case of an asset acquisition, the trade off for lengthening the amortization to 14 years is the new ability to amortize goodwill and thus the elimination of controversies over what constitutes goodwill (and what is allocable to the covenant). That trade off is not relevant to a stock acquisition. The bill's treatment of covenants in stock acquisitions is very harsh.

Issues. The bill does not eliminate controversy as to the allocation of purchase price between stock and the non-compete agreement. In the case of stock acquisitions, fourteen years is too far a departure from the appropriate amortization period—the life of the contract.

Solutions. **To improve the fairness of the treatment of covenants while reducing controversies in stock acquisitions, a safe harbor allocation of value to the non-compete agreement could be established.** The safe harbor could be based on the lesser of the amount agreed to by the buyer and seller or an arbitrary percentage limit such as 20%. In any event, in the case of a stock acquisition, the amortization period should be left as the period agreed to by the buyer and seller. That has not been a source of controversy.

Interests as Lessee—Proposed Section 197(d)(3)(B) of H.R. 3035

Background. Amounts paid to lease property are deductible currently. Under current law, the cost of acquiring a lease, such as the payment to a lessee to acquire the lessee's interest, is generally amortizable over the term of the lease.

Proposed Section 197(d)(3)(B) of H.R. 3035 provided that amounts paid to acquire an interest as a lessee could be treated as a Section 197 intangible, under the definition of "supplier-based intangible." Interests as a lessee of tangible property were amortizable over the remaining term, if the lease is not renewable and the lease is not acquired as part of the acquisition of a trade or business. If renewable or acquired as part of the acquisition of a trade or business, interests as a lessee were amortizable over the 14 year period.

Issue. It is a common practice to negotiate renewal clauses at fair market value, particularly for retail businesses, where businesses that prove to be a success want some protection that they will be entitled to the same rent generally charged by the landlord, and that the landlord at renewal time cannot use his ownership interest in the property as a basis for negotiating an equity interest in the tenant's business.

Also, a one year lease that is renewable for only a single one year term would have been amortized over 14 years.

Solution. Section 197(e)(5)(A) of H.R. 4210 resolved these concerns by generally excluding interests under leases of tangible property from Section 197 treatment.

Contract Rights—Proposed Section 197(d)(4)(B) in H.R. 3035.

Background. Under current law, taxpayers generally amortize the cost of acquiring contract rights over the term of the contract.

Proposed Section 197(d)(4)(B) of H.R. 3035 provided an exclusion from Section 197 for certain contract rights "to the extent provided in regulations." The implication was that all contract rights would be included except those specified in future regulations. Further, action by the IRS would have been necessary to implement the exception. The explanation indicated that the contract rights that would be excluded when the regulations are issued are those of a fixed duration, not renewable, and not acquired as part of the acquisition of a trade or business.

Issues. Taxpayers would have to wait for the IRS to issue regulations in order to exclude from the new rules a wide variety of contract rights that are not in controversy and should not be affected by the proposal. Also, contracts that are renewable under terms subject to change by another party are not indefinite contracts.

Solutions. H.R. 4210 resolved these concerns by eliminating the general inclusion of contract rights.

Government Licenses—Proposed Section 197(d)(1)(D)

Background. The cost of acquiring a governmental license from a third party has been treated by taxpayers and the Tax Court, *Tele-Communications Inc.* v. *Commissioner,* 95 T.C. 36 (1990), as a franchise which is amortizable under Section 1253 (previously 10 years, now 25 years). Rev. Rul. 88–24 in conjunction with prior private letter rulings applies Section 1253 when franchise rights are acquired from a third party (rather than directly from the franchisor).

H.R. 3035, as introduced, would have excluded all government licenses from the definition of a franchise. Further, H.R. 3035 would have provided three separate treatments for the acquisition costs of government licenses and permits, and renewable or indefinite term licenses would not be amortizable at all.

Given the policy objective of eliminating controversy surrounding intangibles, the exclusion of renewable government licenses would have only served to promote controversy and prevent the achievement of the worthwhile goal of the legislation. Under the rules in H.R. 3035, the Internal Revenue Service would likely continue to dispute taxpayers' purchase price allocations between non-amortizable government licenses and amortizable goodwill. As long as there are both amortizable and non-amortizable intangible assets, controversy and litigation would continue to exist in this area.

Additionally, if goodwill and other licenses are deemed to be amortizable, what is the rationale for excluding renewable governmental licenses? All of these are intangible assets that can decline in value. Their economic value is dependent on demand for the particular service or product being licensed, and demand is a function of sociological and technological trends. For example, the government could license additional competitors or the current technology could become obsolete. Therefore, despite the renewal feature of a governmental license, its economic value will change over time.

Treasury stated at the Ways and Means' hearing on H.R. 3035 that the policy for the rule that renewable government licenses would not be amortizable is that some kinds of licenses are more akin to an interest in land, which is not amortizable.

Issues. The term "reasonably expected to be renewed" in H.R. 3035 was unnecessarily vague, since under past practices many government licenses are renewed, but not necessarily under the same terms. If the government can change the terms of the license, then the renewal may result in a different license with a very different intangible value. Also, some types of government licenses are

too new to even have a history upon which a taxpayer can base expectations regarding renewal.

Solution. H.R. 4210 resolves these concerns. It generally provides Section 197 treatment to any license, permit or other right granted by government and excludes from Section 197 treatment a definitive category of government licenses—stand alone purchases of government licenses which entitle the licensee to receive tangible property or services.

Subsequent Dispositions—Proposed Section 197(f)(1)

Background. Under current law, the amount paid for a business is allocated first to assets such as cash, cash equivalents and marketable securities. The remaining cost is allocated to the tangible assets and identifiable intangible assets in proportion to (but not in excess of) their fair market values. The residual, if any, is then allocated to goodwill and going concern value. Any identifiable intangible asset which has a limited economic life that can be estimated with reasonable accuracy is amortized over its useful life. When an intangible asset is sold, gain or loss is calculated and recognized based on the remaining unamortized basis in the particular asset sold.

After a large group of assets or a business is purchased, it is relatively common for later dispositions of various assets to occur. In a large transaction, an entire line of business may be sold.

Proposed Section 197(f)(1) provides that in the case of a disposition of intangible assets that were acquired with other intangibles, losses are not recognized. Since the bill would make no changes to Code Section 1001, gains would still be recognized. Although the taxpayer must pay tax on the gains, the losses would be reflected in an adjustment to the unamortized basis in the remaining intangible assets. The purpose of the rule is to prevent taxpayers from "cherry picking" the short term assets for sale as a way of defeating the simplification associated with averaging all assets at 14 years.

Proposed Section 197(f)(1) also applies to all entities treated as a single taxpayer under Section 41(f). This section aggregates expenditures of all taxpayers "under common control" for purposes of the R&E credit. In the context of this legislation, it could require the tracking of transactions by business organizations that are not even reported on a consolidated tax return.

Issues. This is a rule that raises some fairness concerns for taxpayers. It is not equitable that taxpayers must include gains in current taxable income while deferring losses for as many as 14 years. Also, the rule would require comprehensive and expensive appraisals of many Section 197 assets, because the unadjusted basis of each must be determined in order to be able to compute gain or loss on future dispositions. This valuation requirement is clearly inconsistent with the overriding purpose of the proposed legislation to simplify this area of the tax law.

Solutions. **Adopt a rule deferring gains as well as losses.** This would eliminate needless valuations. Taxpayers could then maintain a single basis account for each acquisition of a trade or business, rather than a separate basis account for each asset. Alternatively, the rule in proposed Section 197(f)(1) could be eliminated. This would provide taxpayer equity, although it is not as preferable from a simplification perspective as a rule to defer gains on subsequent dispositions.

Use of Section 41(f) to identify related or controlled taxpayers should be reconsidered. It seems overly inclusive and unenforceable.

Basis Determinations—In Acquisition of Trades or Businesses

Background. Under current law and regulations, in the acquisition of a trade or business, the basis of identifiable intangible assets is based upon their appraised fair market values in relation to other acquired assets. The basis of goodwill and going concern value are determined under the residual method. That is, the allocation of purchase price is first to Class I assets such as cash and cash equivalents; then among Class II assets, such as marketable securities, in proportion to (but not in excess of) their fair market values; and then among Class III assets in proportion to but not exceeding their fair market values. Any remaining balance is assigned to Class IV, goodwill and going concern value, under the "residual method." If no excess exists, no tax basis is assigned to Class IV. Effectively, allocations stop at whatever point the aggregate purchase price is used up.

The four classes of assets are as follows:

Class I assets: Cash and cash equivalents such as bank accounts.

Class II assets: Liquid assets such as certificates of deposit, marketable securities, etc.

Class III assets: All other tangible assets and identifiable intangible assets, whether or not depreciable or amortizable. This class includes buildings, land, trade names, covenants not to compete, inventory, accounts receivable, as well as certain customer base intangibles.

Class IV assets: Goodwill and going concern.

Issues. Under H.R. 3035 it was not clear how the basis of Section 197 assets would be determined under Code Section 1060 or Code Section 338. Because the amortization period for intangibles is significantly longer than most tangible assets, controversies could still arise between the IRS and taxpayers concerning allocations of purchase price.

Also, in the case of a bargain purchase of a business, as under current law, the accounts receivable and inventory which have relatively certain values would receive the same prorata basis reduction from fair market value as less certain and longer term assets.

Solution. H.R. 4210 resolves this concern. It amends Section 1060 to put all 197 assets in Class IV. Tangible assets and amortizable intangibles that are not Section 197 assets (such as patents) would maintain their current treatment in Class III.

However, improvement to current law would be to modify Class II to include other short term assets such as accounts receivables and inventory whose values, like marketable securities, are readily determinable based upon independent third party transactions in the marketplace.

Retroactivity/Resolving Existing Controversies—Effective date.

Background. The Internal Revenue Service's practice of disallowing the amortization of a wide variety of intangibles on the basis that they are indistinguishable from goodwill has resulted in a large backlog of taxpayer controversies in audit, appeals, and litigation. This situation results in the waste of a lot of otherwise productive resources, both by the Internal Revenue Service and by taxpayers.

H.R. 4210 includes several taxpayer elections. One election would permit taxpayers to apply the new rules to intangibles acquired between July 25, 1991 (the date of introduction of the original proposal) and the date of enactment. This election was intended to prevent taxpayers from delaying plans to acquire intangibles during the period of legislative uncertainty. Alternatively, taxpayers can elect to apply the new rules retroactively to past open tax years, but with a 17-year amortization period rather than 14 years. The 17-year election is designed to permit taxpayers to "clear the decks" of intangible controversies.

Issues. The 17-year election has been estimated by the Joint Committee on Taxation as losing significant revenues. In addition to the revenue shortfall, there are technical issues with the election. First, once the election is made, H.R. 4210 section 4501(g)(3)(D) provides that the election applies to the taxpayer and any other taxpayer "under common control" with the taxpayer under IRC section 41(f)(1)(A) and (B). Since the taxpayers to which the election applies may not necessarily file consolidated returns, or may not even be under the control of a U.S. parent, this raises a host of concerns about potential reporting burdens, which corporation could make the election, and how taxpayers could comply or the IRS could enforce such a rule. Second, the Committee Report should discuss which type of agreements with the IRS will be treated as closing particular tax years. Closing agreements and form 870 AD agreements reached between the IRS and taxpayers may resolve the intangible asset dispute along with any other audit issues, but the statute of limitations may not have expired for the year.

Alternative Solution. **We support the Committee's efforts to resolve past disputes in a revenue neutral manner that does not adversely affect companies that are uninvolved in these controversies. Moreover, the election back to July 25, 1991 seems necessary for basic fairness to taxpayers who had transactions in progress during this period.**

In this context, we believe it is desirable for the Committee to go even farther to provide certainty for resolving existing controversies and put an end to the inordinate expenditure of resources by taxpayers and the government on this issue. We would prefer a statutory resolution of existing controversies along the lines of S. 1245 introduced by Senators Daschle and Symms.

COUDERT BROTHERS,
New York, NY, May 11, 1992.

Mr. WAYNE HOSIER,
Committee on Finance,
U.S. Senate,
Washington, D.C. 20510

Mr. ED MIHALSKI, *Minority Chief of Staff,*
Committee of Finance,
U.S. Senate,
Washington, DC.

Dear Mr. Hosier/Dear Mr. Mihalski: The purpose of this letter is to strongly urge the United States Senate to enact H.R. 4210, or similar legislation, to clarify the tax treatment of amortizable intangibles for both future and past transactions. Specifically, this letter will propose certain modifications to the provisions of H.R. 4210 which would make the 17-year retroactive election provided in such legislation revenue neutral.

SUMMARY

It is acknowledged by the Treasury Department, professional groups, and affected taxpayers that the availability of the 17-year retroactive election contained in H.R. 4210 would avoid costly and unproductive controversies between taxpayers and the Internal Revenue Service (the "IRS") which, following the enactment of H.R. 4210, will have no precedential value. However, the concern has been raised as to whether the 17-year retroactive election will lose revenue, although the revenue estimate originally made with respect to H.R. 4210 at the time it was passed by Congress, showed this legislation would result in a revenue increase.

To ensure that the 17-year retroactive legislation does not result in any significant revenue loss, we propose that H.R. 4210 be modified in two respects. First, taxpayers should be required. to make the 17-year retroactive election no later than December 31, 1992. As explained below, such a deadline is the key to avoiding a loss of tax revenue, because it will force almost all affected taxpayers to make the election in order to avoid the risk of future adverse judicial decisions concerning the amortization of intangibles. Second, the 17-year retroactive election should be limited to transactions consummated after May 6, 1986, the effective date of Section 1060 of the U.S. Internal Revenue Code of 1986, as amended, (the "Code"). Limiting the retroactive election to post-Section 1060 transactions will preclude taxpayers, who employed the highly aggressive purchase price allocation techniques which were available prior to the enactment of Section 1060, from obtaining an unfair tax benefit through the making of a 17-year retroactive election. It would also limit the election to tax years in which the IRS and taxpayers have yet to incur a substantial amount of contest costs as evidenced by the report issued by the United States General Accounting Office (the "GAO") entitled *"Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets"* (GAO/GGD–91–88). The GAO conducted an internal IRS survey in mid-1989 of all unresolved, or open, audit cases in their examination, appeals, or litigation units. These cases generally included tax returns for tax years 1979 through 1987. Moreover, extending the 17-year retroactive election to post-Section 1060 transactions is consistent with the clear objective of Congress to clarify the appropriate allocation of purchase price consideration for transactions consummated after May 6, 1986.

The rationale for these proposed legislative modifications is discussed in further detail below.

DISCUSSION

Benefit of Retroactivity. In recent years, many of our clients have been engaged in protracted and extremely costly negotiations with the IRS concerning the appropriate tax treatment of intangible assets purchased as part of various acquisitions undertaken to expand such clients' business operations. A substantial number of such transactions have yet to be audited for prior taxable years, and our clients face the prospect of costly IRS controversy proceedings regarding the issue of the appropriate level of intangible asset amortization deductions.

The enactment of H.R. 4210 would eliminate uncertainty with respect to future acquisitions and would avoid the protracted and expensive disputes with the IRS which have absorbed significant amounts of our clients' time in the past and have required an enormous expenditure of resources of time of client personnel and fees paid to attorneys, accountants and appraisers. H.R. 4210 is revenue-neutral as ap-

plied to future transactions and is supported in concept by the Treasury Department, various bar associations, professional organizations and numerous industry groups.

The principal question raised with respect to H.R. 4210 is the concern that the 17-year retroactive election presently provided in the legislation will have a significant negative revenue effect. All parties recognize that, if the provisions of H.R. 4210 constitute good tax policy for future transactions, then, by definition, such legislation should prove useful in resolving potential disputes between taxpayers and the IRS with respect to pre-1992 transactions. Assistant Secretary Goldberg, in his April 28, 1992 testimony before the Senate Finance Committee stated that:

> "we recognize that there are numerous controversies between taxpayers and the Internal Revenue Service concerning the amortization of intangibles, and that there will be more to come for years prior to 1992. These disputes are costly to the private sector and the Government. We share Congressional concern over the prospect of continued litigation gridlock, particularly over issues of no ongoing significance. *We would readily embrace a legislative solution that would resolve all open cases fairly, equitably, immediately, and at no additional cost to taxpayers and the Government."* (Emphasis added).

Loss of Revenue—Adverse Selection. Assistant Secretary Goldberg expressed concern regarding the 17-year retroactive election contained in H.R. 4210 because, as a result of the inclusive provision of H.R. 4210, recent analysis suggested that the legislation would lose significant revenue. In determining whether the 17-year retroactive election contained in H.R. 4210 will lose significant revenue, the first point that should be noted is that the 17-year amortization period provided in the event of such an election is longer than the 14-year amortization period set forth for future transactions in the legislation. The 14-year amortization period generally is believed to be revenue-neutral. Thus, a 17-year retroactive election actually would appear to raise revenue for the Government if the Government could be reasonably assured that substantially all affected taxpayers would make the retroactive election provided for in the legislation.

It has been asserted by critics of retroactivity that the revenue loss which may arise as a result of the 17-year retroactive election principally will result from "adverse selection." Under this concept of "adverse selection," those taxpayers who would benefit from the 17-year election would make the election while those taxpayers who have strong arguments for the amortization of intangible assets over shorter lives than 17 years, would not make the election. Moreover, it is asserted that certain taxpayers will receive significant refunds as a result of making the 17-year retroactive election.

Election Deadline. We believe that certain modifications can be made with respect to the retroactive election provisions of H.R. 4210 to ensure that the legislation remains revenue neutral. First, and most important, it is critical that taxpayers be provided with a December 31, 1992 deadline to make the 17-year retroactive election. Such a time deadline, in effect, would compel almost all taxpayers to make the 17-year retroactive election without actually adopting the mandatory requirement of a 17-year amortization life for intangible assets purchased in past transactions. There are few taxpayers who would not make a 17-year election and instead choose to face the uncertainties of future judicial authority and IRS actions concerning the amortizability of various categories of intangible assets. In the face of a December 31, 1992 election deadline, few taxpayers would take the risk of future adverse legal authority and would make the election even if it resulted in paying more taxes in order to avoid substantial controversy costs and the risk of adverse future court decisions. We believe that almost all affected taxpayers will make the 17-year retroactive election which, at least, should prove revenue neutral.

In addition, the retroactive election provisions of H.R. 4210 should be further revised to provide that all taxes and accrued interest for all taxable years for which such election was made would be payable within 2-1/2 months of the making of such election. We anticipate that such a payment deadline would actually generate an immediate revenue increase.

Cut-Off Date of May 6, 1986. Second, to further eliminate any negative revenue effect arising for the 17-year retroactive election, Congress may wish to consider limiting such election to acquisitions consummated alter the effective date (i.e., May 6, 1986) of Section 1060 of the Code. Congress adopted Section 1060 in an attempt to resolve conflicts between taxpayers and the IRS regarding the allocation of purchase price of acquired assets. Allowing taxpayers to make a retroactive election with respect to post-May 6, 1986 acquisitions should make the remaining conflicts in the allocation of purchase price (i.e., allocation to intangible assets) consistent

with the purposes of Section 1060. In transactions consummated prior to the effective date of Section 1060 of the Code, taxpayers often took relatively aggressive positions with respect to the allocation of purchase price among different assets. If taxpayers are precluded from making a 17-year retroactive election with respect to intangible assets acquired in pre-Section 1060 transactions, the IRS will have the opportunity to challenge these more aggressive transactions which should be more vulnerable to IRS attack than post-1986 transactions. Thus, any negative revenue effect of the 17-year retroactive election could be partly avoided by limiting the availability of such election to intangibles acquired after the effective date of Section 1060.

In conclusion, if the 17-year retroactive election provided in H.R. 4210 is modified to provide that (1) the election must be made by December 31, 1992, and (2) the election can only be made with respect to intangibles purchased in connection with the acquisition of a trade or business consummated after May 6, 1986, the 17-year retroactive election should be largely revenue-neutral and a substantial portion of the present backlog of tax controversies concerning the amortization of intangibles should be eliminated.

If you have any questions concerning the foregoing, please do not hesitate to call the undersigned at (212) 880–4470.

Very truly yours,

EDMUND S. COHEN.

STATEMENT OF THE DFS GROUP L.P.

DFS Group L.P. appreciates the opportunity to submit these comments for inclusion in the record of the hearing held by the Senate Finance Committee on proposals to amend the tax laws to provide changes with regard to the taxation of intangibles. While DFS Group L.P. applauds in concept the effort being undertaken by the tax writing committees to provide additional certainty in this area, we believe that it is inappropriate to arbitrarily lengthen the useful life of intangible assets in those cases where there is a well established useful life, no controversy with the IRS exists, and the concession is not renewable without the payment of fair market value consideration to the governmental unit.

In particular, government concessions should continue to be allowed to be amortized over the period to which the payments for such concessions relate. Although government concessions are intangible assets, their useful life is easily determinable by reference to the period for which they are granted. Amortization over a different, arbitrary period will result in a significant mismatch of revenues and expenses and may create an allocation issue where none currently exists.

The uncertainty and controversy between the IRS and taxpayers the legislative proposals are intended to address arises from the treatment of customer-based intangibles and goodwill. The present law necessity of allocating acquisition price among such intangibles and the determination of their useful life imposes significant compliance costs on taxpayers and, due to the controversial nature of such determinations, leads to frequent, expensive, and time consuming controversies between taxpayers and the IRS. Thus, it may be appropriate to require customer-based intangibles to be amortized over a single, arbitrary useful life.

On the other hand, the value of a government concession has no material customer-based component. The value of such a concession is the right to sell certain items at a certain place for a certain period of time. Payment is made to the governmental entity granting the concession for that certain period of time. Both the amount of the payment and the period to which it relates are easily determined with reference to the terms of the concession itself.

It is inappropriate to arbitrarily change the tax treatment of intangible assets which are not customer-based and are not the subject of controversy between taxpayers and the IRS.

The Conference Committee to H.R. 4210 recognized this principle in connection with the treatment of software, leases, and certain other intangible assets which it excepted from the arbitrary life otherwise provided in that legislation. However, the Conference Committee did not address the treatment of government concessions, and the language of that bill appears to require government concessions be treated as section 197 intangibles, to be amortized over 14 years.

We urge the Senate Finance Committee to address this problem in the case of government concessions by providing that section 197 intangibles do not include any contractual right granted by a governmental unit, or an agency or an instrumentality thereof, if (1) such right has a fixed duration and (2) is not renewable without

the payment of fair market value consideration to the governmental unit for the period to which the renewal applies.

DESCRIPTION OF TYPICAL GOVERNMENT CONCESSION TO SELL "DUTY FREE"

DFS typically operates as the exclusive "duty free" or "in bond" seller at an airport, under a concession granted by the airport authority pursuant to a competitive bidding process. DFS usually is required to make payments for each year of the concession to the airport authority.

The concession exists for a fixed period of time, typically five years. At the conclusion of the fixed period, the airport authority generally conducts a new competitive bidding process to determine who will be assigned the concession for the next fixed period. The business holding the concession for the prior period receives no special consideration in this new bidding process. In certain situations, the governmental authority having the power to grant the concession may choose to negotiate an extension of the current concession. However, it is not required to do so and will only extend the concession if it is satisfied that the additional payments to be required for the period of the extension represent fair market value consideration for that period.

A typical duty free concession consists of several rights, including the exclusive right to sell "duty free" or "in bond" merchandise within an airport or airport terminal, the exclusive right to deliver "duty free" or "in bond" merchandise to international passengers departing from the airport or terminal, and the exclusive right to use certain physical space for a specific purpose. Of these rights, the rights to sell "duty free" are by far the most valuable. The payments other vendors make for the use of similar space, but without the exclusive right to sell "duty free," are a small fraction of the payments made for the duty free concession.

IMPACT OF LANGUAGE IN H.R. 4210

In general

The language in H.R. 4210 appears to treat a duty free concession as a section 197 intangible and, at least as to the portion of concession payments attributable to the right to sell "duty free," appears to require payments for the fixed period of the concession to be amortized over 14 years rather than the period to which the payments relate.

Mismatch of revenues and expenses

To the extent possible, expenses should be recognized in the same period as the revenues to which they relate. The revenues attributable to a duty free concession for a fixed period are recognized over that fixed period. The expenses attributable to the concession should be recognized over the same period, and not over some different, arbitrary period.

Duty free appear not to be excluded from section 197 as either leases or franchises

The language in H.R. 4210 does provide an exception from section 197 for an interest in real property (such as a lease), or the acquisition of an existing lease. The greater portion of payments made for a duty free concession are not for an interest in real property. A duty free concessionaire pays substantially more than other concessionaires pay for the use of airport space without the right to sell duty free. This excess is properly viewed as in exchange for the right to sell duty free, rather than for the lease of physical space.

The language in H.R. 4210 also provides that certain contingent payments for franchise rights are also excluded from section 197. This exclusion appears to be insufficient to cover a duty free concession for two reasons.

First, the language in the House passed version of H.R. 4210 suggests that a grant of a right by a governmental body is not necessarily a franchise. Otherwise, there would be no reason to refer separately to rights granted by a governmental body.

Second, the typical duty free concession requires substantial fixed minimum payments over the term of the concession which would not be treated as a contingent payment under the bill.

Language in H.R. 4210 creates a new allocation issue

The treatment of duty free concessions under the present language will create a new allocation issue of the type the intangibles provision is designed to prevent. Because a duty free concession consists of both the right to occupy physical space (not a section 197 intangible) and the right to sell duty free (apparently a section 197 intangible), taxpayers acquiring concessions would apparently be required to allocate amounts paid pursuant to the concession between the two. This allocation is

not a material issue under present law since both rights are considered to have the same useful life. The language of H.R. 4210 makes the allocation a material issue and creates the anomalous result of requiring the portion of the concession payment attributable to the lease to be amortized over the period to which it relates and the portion attributable to the right to sell duty free to be amortized over 14 years.

PROPOSAL TO CORRECT LANGUAGE IN H.R. 4210

The problems created by the language in H.R. 4210 should be addressed by providing that section 197 intangibles do not include any contractual right granted by a governmental unit or an agency or an instrumentality thereof if such right has a fixed duration and is not renewable without the payment of fair market value consideration to the governmental unit for the period to which the renewal applies.

It is noteworthy that this corrective language generally follows the approach taken in the original version of the intangibles proposal contained in H.R. 3035. That bill would have excluded all governmentally granted rights from section 197 treatment. At the request of broadcasters and others, the original language was modified to bring governmentally granted rights that do not have a well established useful life, such as communications licenses, under section 197 and allow their amortization over 14 years. In addressing concerns with these other kinds of governmentally granted rights, the inappropriate treatment of government concessions was, we believe, inadvertently created.

The proposed corrective language differs from the language in H.R. 3035 as introduced in three respects. First, the proposed corrective language requires that the right granted by the governmental entity not be renewable without the payment of fair market value consideration for the period to which the renewal applies. This is intended to limit the rule to those rights whose original acquisition cost is related to the current term of the concession. If fair market value for any renewal term must be paid, that payment is the amount attributable to the renewal.

Second, unlike the language of H.R. 3035, the proposed corrective language is not limited by the phrase "to the extent provided in regulations." Application of the rule should not depend upon when and in what manner the Secretary of the Treasury discharges his obligation to write regulations. Taxpayers should be able to rely on the provision beginning with the enactment of the provision, and not have to wait for regulations to be proposed and finalized to determine whether or not it applies.

Third, the proposed corrective language would apply to rights acquired in a transaction involving the acquisition of assets constituting all or a substantial portion of a trade or business, as well as grants of new rights or the acquisition of such rights in a "stand-alone" purchase. This is consistent with the treatment of other intangible assets, such as leases, that are also excluded from section 197. Rights granted by a governmental entity which are not renewable without the payment to the governmental unit of fair market value consideration should not be treated differently depending upon how they are acquired. The issues concerning the proper matching of income and expenses are the same in all cases.

Again, we appreciate the opportunity to submit these comments on this important issue, and would be pleased to answer any questions which the members of the Committee may have about our testimony.

STATEMENT OF ECOLAB INC.

I am writing in my capacity as Vice President—Tax and Public Affairs of Ecolab Inc. in regard to the April 28, 1992 Senate Finance Committee hearing on simplifying the tax treatment of intangible assets.

Ecolab is the leading developer and marketer of premium cleaning, sanitizing and maintenance products and services for the hospitality, institutional and industrial markets. Our customers include hotels and restaurants, foodservice and healthcare facilities, dairy plants, and food and beverage processors around the world. Founded in 1924, Ecolab is headquartered in St. Paul, Minnesota and currently employs more than 7,000 people in 25 countries.

We commend you for exploring possible solutions to the continuing controversy between taxpayers and the Internal Revenue Service regarding the tax treatment of intangible assets.

The current state of the law with respect to the tax treatment of intangible assets leads to both costly disagreements between taxpayers and the IRS and to inconsistent treatment for similarly situated taxpayers.

A statutory framework for the tax treatment of intangible assets would lead to certainty in the tax law and consistent treatment among taxpayers. By way of precedent, the legislative approach to fixed asset depreciation deductions serves as

an example of a workable and fair solution to otherwise uncertain tax treatment. The statutory history with respect to adoption of the Accelerated Cost Recovery System in 1981 rings true today in the area of intangibles.

> "The committee heard copious testimony that the present rules are too complex. These rules require determinations on matters, such as useful life and salvage value, which are inherently uncertain and, thus, too frequently result in unproductive disagreements between taxpayers and the Internal Revenue Service. Current regulations provide numerous elections and exceptions which taxpayers—especially, small businesses—find difficult to master and expensive to apply. The committee believes that a new capital cost recovery system should be structured which de-emphasizes the concept of useful life, minimizes the number of elections and exceptions, and so is easier to comply with and to administer." [Senate Report No. 97–144, 1st Session, page 47]

We support efforts to bring certainty and fairness to this unsettled area of tax law through a statutory framework, as was implemented in 1981 for the depreciation of fixed assets.

If you have any questions regarding the foregoing, please contact me at (612) 293–2642. Thank you for your consideration of these comments.

STATEMENT OF THE EDISON ELECTRIC INSTITUTE

The Edison Electric Institute (EEI) appreciates this opportunity to provide written comments for the April 28, 1992 hearing before the Senate Committee on Finance with respect to the tax treatment of goodwill and certain other intangibles. We appreciate the interest—of this Committee in holding a hearing on this important topic. EEI is the association of electric companies. Its members serve ninety-eight percent of all customers served by the investor-owned segment of the industry. They generate approximately seventy-eight percent of all the electric energy in the country and provide service to more than seventy-five percent of all ultimate customers in the Nation.

SOUND TAX POLICY

EEI strongly supports the concept of simplifying the tax treatment of intangible assets. While Congress has devoted enormous amounts of time and resources to establishing depreciation methods and periods for tangible assets, it has devoted relatively little attention to the amortization rules for intangible assets. This has left the issue of determining amortization rules of intangibles to the courts. The courts have created a body of case law that is both complex and uncertain and this causes ongoing problems for both taxpayers and the Internal Revenue Service (IRS). EEI believes that the Internal Revenue Code of 1986 should be amended to provide for the amortization of intangible assets in order"to eliminate uncertainty and controversy. These points were made by EEI in a written statement for the record submitted to the Committee on Ways and Means with respect to H.R. 3035, a bill introduced by Chairman Rostenkowski of the Committee on Ways and Means. Although H.R. 4210, the Tax Fairness and Economic Growth Act of 1992, was vetoed by the President, the bill contained the "substance of H.R. 3035. Importantly, Congress recognized that tax law simplification of intangible assets is necessary. To that end, we are pleased that this Committee has now held hearings on this important subject.

The concept of matching income and expense in the same period(s) is a fundamental principle of income taxation. Presently, many intangible assets generate gross income; however, no deduction related to the cost of these intangible assets is permitted to offset that income. The recognition of intangible assets as amortizable is an advance in tax policy because it recognizes the matching concept. That is, the taxpayer should recognize the cost of intangible assets over the period of time that those assets produce income. Current law permits the amortization of an intangible asset only in those cases when the intangible asset has a limited life or a special statutory provision applies. If an intangible asset is created in the acquisition of a business, a taxpayer often cannot match the cost of that asset against the periods annual income in which the income is generated by the business. Consequently, the taxable income will be overstated in those periods. Conversely, when the business is sold, the profit will be understated because the entire cost is deductible at that time.

A tax system that purports to tax net income should fairly measure net income. Otherwise, the tax system is not neutral and affects the economic decisions of tax-

payers. The failure of the tax code to include a clear, general system of amortization for certain intangible assets is an onerous burden for both the government and the taxpayers. Assistant Treasury Secretary for Tax Policy, Kenneth W. Gideon, stated in a letter regarding H.R. 3035, that "By making goodwill amortizable, the U.S. tax laws would move closer to generally accepted accounting principles and the tax accounting principles utilized by other industrialized nations." Just like a machine or a building, an intangible asset produces income and represents a cost of doing business. Failure to permit that cost to be matched against related income is poor tax policy.

The recovery period for intangible assets necessarily will be somewhat arbitrary. However, the depreciable lives of most physical assets today has little connection to their economic useful lives. Our economy and tax system are too complex to permit determination of useful lives on individual facts and circumstances. The important point is to allow businesses to recover the capital costs of income-producing assets over a reasonable period. H.R. 3035 generally corrects the problem through the institution of a single fourteen year amortization period for intangible assets.

In our view, H.R. 4210 corrected a deficiency in H.R. 3035. H.R. 4210 allows fourteen year amortization of any qualifying license, permit or other governmentally granted right, even if the license, permit or right is extended indefinitely or is expected to be renewed for an indefinite period. However, H.R. 4210 also provided a special rule wherein a taxpayer which acquired a group of intangibles in a single transaction (or a series of related transactions) could not take a deduction on any intangible in the group until the last asset is disposed of or became worthless.

EMISSION ALLOWANCES CLARIFICATION NEEDED

The Clean Air Act Amendments of 1990 instituted a market based emissions control program by establishing a new system whereby the Environmental Protection Agency (EPA) is to issue allowances for the emission of sulfur dioxide (SO_2), based upon emissions during a base period. This program is designed to reduce emissions in two phases beginning in 1995 and in 2000. The program will utilize a market based program which will allow emission control programs to be based on economic decisions. An emission allowance is the right to emit one ton of SO_2 during one year. The EPA has issued proposed regulations on the emissions program.

H.R. 4210, as written, could be interpreted to adversely affect utilities by requiring the amortization of emission allowances over a fourteen year period. Such allowances, granted by the EPA are not subject to gradual exhaustion as most amortizable assets, but rather the allowances generally will be used in the year in which they are acquired. A second area of concern regarding emission allowances is the possibility of delay in recovering the cost of any allowances acquired in a transaction or series of transactions until the last allowance in the group is disposed of or becomes worthless.

EEI does not believe that Congress had emission allowances in mind when it considered the intangibles legislation. The licenses and other governmental 'rights described in the Conference Committee's Explanatory Statement of the intangibles provision of H.R. 4210 (*e.g.*, liquor license, airline slots, a broadcasting license) constitute rights to conduct the taxpayer's business over a substantial period of time. An emission allowance, on the other hand, permits the utility to emit one ton of SO_2 in one year with no residual value after its utilization. Also, the purpose of intangibles legislation is to clarify controversial aspects of the tax treatment of intangibles. As mentioned below, EEI believes that the tax treatment of emission allowances under current law is clear.

EEI realizes that a large number of emission allowances will be acquired by utilities from the EPA at no cost; and, therefore, will have no basis for amortization in the hands of the recipient. See Revenue Ruling 92–16, 1992–12 I.R.B 5. However, allowances may be bought and sold and transferred in other transactions in which a basis in them is acquired by the transferee. EEI believes that current law is clear that the basis in emission allowances is not depreciable or amortizable but is to be recovered by the holder "when the allowance is used, sold or becomes worthless. EEI urges this Committee to continue existing law in this area by clarifying that emission allowances are not subject to the amortization provisions of any intangible legislation.

Income and expense would be mismatched if a utility purchased an allowance for use in the year of purchase, or soon thereafter, and was required to deduct the cost of the allowance over a fourteen year period. It would also be a mismatch of income and expense to require a utility to delay its recovery of the cost of an allowance acquired along with thousands of other allowances until the last allowance of the group is used, sold or otherwise unused.

In EEI's view, as expressed to the IRS, " . . . a taxpayer should be able to deduct the basis of an allowance under [Internal Revenue] Code section 162(a) in the taxable year in which the allowance is used." An emission allowance, unlike most governmental licenses, is limited both as to time and scope so that an allowance is totally consumed within one year.

The following description included in the legislative history as part of the Ways and Means Technical Explanation of H.R. 4287 (Tax Simplification) and as part of the Conference Committee's explanation of the House Bill in its Explanatory Statement of H.R. 4210 should be modified to clarify that an emission allowance is not a "section 197 intangible" asset amortizable under the Act. Our suggested modification is noted below:

> "Certain rights to receive tangible property or services. The term 'section 197 intangible' would not include any right to receive tangible property or services under a contract (or any right to receive tangible property or services granted by a governmental unit or an agency or instrumentality thereof) if the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business."
>
> NOTE: [Additionally, the cost of acquiring an emission allowance to emit one ton of sulfur dioxide provided by the Clean Air Act Amendments of 1990 would be deducted during the taxable year in which it is used.]

OTHER GOVERNMENTAL LICENSES

Another type of governmental license where tax treatment needs clarification is a license to operate an electric generating plant. For example, the Nuclear Regulatory Commission licenses nuclear generating plants and the Federal Energy Regulatory Commission licenses hydroelectric generating plants. In each instance, the license is plant specific for a specified period of time. Current tax treatment has been to capitalize original licenses as part of the tangible plant cost and depreciate such costs over the depreciable life of the plant. Clarification should be provided that utilities may continue to capitalize such costs and depreciate them as part of the tangible asset, or alternatively, treat such costs as a Section 197 asset by capitalizing and amortizing them over the applicable period.

SUMMARY

In summary, if the Committee proposes legislation similar to the intangibles provision of H.R. 4210, EEI urges it to clarify that an emission allowance under the Clean Air Act Amendments of 1990 is not covered by such legislation. We also recommend that such legislation specify that licenses to operate utility plants issued by agencies of the federal government may continue to be depreciated as part of the cost of the tangible asset or, alternatively, such licenses may be amortized over the applicable period for a Section 197 asset. EEI appreciates the opportunity to present its views on this important issue.

STATEMENT OF THE ELECTRONIC INDUSTRIES ASSOCIATION

The Electronic Industries Association (EIA) is pleased to submit its views for the record of the April 28, 1992 hearing held by the Finance Committee on the tax treatment of intangible assets.

EIA is the oldest and largest trade association for the U.S. electronics industry, and is comprised of more than 1,000 member companies involved in the design, manufacture, distribution and sale of electronic parts, components, equipment and systems for use in consumer, commercial, industrial, military and space use. Overall, the industry was responsible for more than $271 billion in factory sales of electronics in 1991, of which approximately $30 billion were exports.

For purposes of the discussion below, we will focus our remarks on the impact of H.R. 4210 and S. 1245 upon the software and high technology industry.

GENERAL COMMENTS

Section 4601 of H.R. 4210 provides for an amortization deduction over a 14-year period for the capitalized costs of certain intangible property (including goodwill) that is acquired and held by a taxpayer in connection with the conduct of a trade or business (a "section 197 intangible"). This rule would apply to the intangible property whether the property was acquired as part of the acquisition of a trade or business or as a single preexisting asset.

Computer software that is not acquired in a transaction involving the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business, or computer software that (1) is readily available for purchase by the general public, (2) is subject to a non-exclusive license, and (3) has not been substantially modified, is not treated as a section 197 intangible subject to the 14-year amortization period. Computer software that is currently deductible (not capitalized) continues to be currently deductible under the bill, but if a depreciation deduction is permitted for software that is not a section 197 intangible (e.g., software that is taken into account as part of the cost of computer hardware or other tangible property), the amount of the deduction is determined by amortizing the adjusted basis of the software ratably over a 36-month period that begins with the month the software is placed in service.

S. 1245 provides that if a taxpayer demonstrates through any reasonable method that (1) a customer base, market share or similar intangible item has an ascertainable value separate and distinct from other assets (including goodwill and going concern value) acquired as part of the same transaction and (2) the intangible item has a limited useful life which can reasonably be estimated, then the basis of the intangible shall be amortized over such useful life.

These bills purport to simplify the Code and, in effect, lessen or eliminate the ongoing controversy over the amortization of acquired intangibles. EIA supports this objective and recognizes that some "rough justice" is an inevitable byproduct of simplification and that such efforts unavoidably distort the amount of one industry's income and expenses in favor of another's. Our members particularly objected to H.R. 3035, which was the predecessor to H.R. 4210, because the amortization period for the computer and high technology companies' products was disproportionately lengthened in order to 14 years in order to provide certainty for other industries and practices, such as the amortization of goodwill. For example, we believed that H.R. 3035, as introduced, would have significantly affected the competitive position of our members who either sell software or who use software in their computer systems, given that the useful life of software is generally recognized as 5 years or less.

SPECIAL RULE FOR SOFTWARE

While we welcome the fact that, in response to comments from us and others, certain types of software are excluded from the current version of H.R. 4210, we believe that it is important to state for the record the reasons why this exclusion is necessary, and to recommend an expansion of this exclusion and certain additional changes to H.R. 4210.

Many of the other intangibles covered by H.R. 4210, such as workforce and goodwill, cannot be valued separately from the business to which they are related. By contrast, software more closely resembles a tangible asset in that it can be identified readily and its economic life can be measured with reasonable accuracy. Moreover, the GAO report on the tax treatment of intangibles issued in August of 1991 indicates that disputes between taxpayers and the Service over the value of technology represents a minor component of taxpayer valuation disputes.

Also, it has generally been recognized by both the Service and taxpayers that software has a short useful life (5 years or less). As noted above, the existence of an estimated useful life is in contrast to other intangible assets whose useful life is much harder to define. By anyone's measure, a 14-year old amortization period for software is much longer than the life of the product.

An artificially long useful life for software creates a disincentive to modernize operations. Legislation that would require software to be amortized even after the software is replaced with new, state-of-the-art software would create a strong disincentive to develop new software as quickly as possible, since the tax system would impose an additional cost of the software previously developed. This disincentive may delay the modernization of operations that has helped to maintain the competitive advantage of the U.S. high technology industry.

Finally, EIA supports the position that internally developed software applications should qualify for the bill's exception for self-developed intangibles. This should be the case even if such applications are developed in connection with third parties that assist or are joint venturers in developing the particular software.

SUGGESTED ADDITIONAL MODIFICATIONS TO H.R. 4210

1. Congress should consider expanding the software exception to certain other high technology intellectual property. The discussion above explains why a special rule for software is required. These arguments also justify treating other certain high technology intangibles like software for purposes of the bill. Certain intellectual property, such as advanced formulae, processes or design patterns, is very simi-

lar to software in that its expected life is much shorter than 14 years, and the ability to make changes quickly in these areas is crucial to a company's success.

Increasingly, the major growth in U.S. electronics is expected to come from products which have a high intellectual property content. If H.R. 4210 is passed in its present form, without recognition of the shorter lifespan of these processes, then the cost of new products developed using cutting-edge intellectual property technologies will rise—thus, reducing the competitive position of high technology U.S. companies in the global marketplace.

2. Congress should consider exempting software or other high technology that is purchased through the acquisition of all of the company's assets. Under H.R. 4210, software that is acquired in a transaction that involves the acquisition of substantially all of a company's trade or business would be subject to a 14-year amortization period. We think such a limitation is unwarranted here. In many cases, the company is acquired primarily to acquire the software that has been developed. We strongly suggest that H.R. 4210 be amended to take that factor into account.

3. Congress should consider eliminating the requirement that software subject to the bill be depreciated over 3 years. In many cases, the 3-year period is too long; much software that is not immediately expensed is depreciated over a shorter period.

SUMMARY

A 14-year amortization period for software and other high technology intangibles, which is much longer than that prescribed in other countries, would affect the competitiveness of U.S. firms that sell or that use U.S. software or other high technology. Moreover, the longer amortization period would provide a severe disincentive for U.S. companies to use more advanced intellectual property technology when business reasons dictate. Providing disincentives for such development, which is clearly one area where the United States has traditionally been competitive with other global economies, as a trade-off for providing a faster write-off period for other intangibles or for "simplification" undermines the Committee's goal of enhancing overall U.S. global competitiveness.

EIA appreciates the opportunity to share the views of its members with the Committee and I invite your staff to contact me at (202) 457–4925 with any further questions.

STATEMENT OF HOUSTON INDUSTRIES INC.

Houston Industries Incorporated ("HII") submits the following comments for the April 28, 1992 hearing on H.R. 3035, as amended and incorporated into H.R. 4210, and related issues. These comments specifically address the provisions of H.R. 3035 and H.R. 4210. The principles enumerated herein may be applied, however, to all proposed legislation regarding the tax treatment of intangible assets.

HII is a diversified holding company. HII files a consolidated U.S. Corporation Income Tax Return with its various subsidiaries including Houston Lighting and Power Company ("HL&P") KBLCOM Incorporated ("KBLCOM"); and Utility Fuels, Inc. ("UFI"). HL&P is a regulated public utility, engaged in the generation, transmission, distribution and sale of electric energy, serving an area of the Texas Gulf Coast Region of approximately 5,000 square miles. KBLCOM is one of the twenty largest cable television system operators in the country, serving approximately 1,000,000 customers in nine states. UFI provides coal and lignite supply services to HL&P.

Recent Congressional attempts to simplify and clarify the tax treatment of intangible assets culminated in the passage of H.R. 4210, the Tax Fairness and Economic Growth Bill of 1992. This bill was vetoed by the President on March 20, 1992. Congress's efforts to simplify and clarify the tax treatment of intangible assets are most commendable. HII and, we believe, the vast majority of parties involved in this area of taxation continue to support these efforts.

The portions of H.R. 4210 dealing with intangible assets were a marked improvement of its predecessor legislation, H.R. 3035. H.R. 3035 excluded certain renewable government licenses from its amortization provisions. The Cable Communications Act of 1984 generally requires a company to possess a government license in order to provide cable television service. The House Ways and Means Committee conducted hearings on H.R. 3035. A number of taxpayers, including HII, expressed concern at the proposed inequitable treatment of governmental licensees and the bill's failure to simplify and clarify the tax treatment of intangible assets.

H.R. 4210 amended H.R. 3035 to include renewable government licenses in the intangible assets subject to the amortization provisions. This amendment, with re-

gard to intangible assets, instilled a greater degree of equality and certainty in the legislation and is to be applauded.

The Government Accounting Office ("GAO") Report on Tax Treatment of Intangible Assets identifies two basic policy issues as paramount in considering any revisions to the current tax rules for amortizing intangible assets. Those two issues are improving the matching of business expenses with revenue to better reflect income and lessening administrative burden on the taxpayer and the Internal Revenue Service ("IRS").

By allowing the amortization of goodwill and other intangibles, including renewable government licenses, H.R. 4210 satisfies the first policy issue raised by the GAO. Virtually all tangible and intangible assets used in the production of business income decline in value over time. These assets are used, or waste away, in the production of income. Measuring the exact decline in the value of an intangible asset in a period is generally not possible in a cost effective manner. Recognizing this limitation, tax law, as well as financial accounting, has adopted a principle of systematic and rational allocation of the cost of an asset to the periods from which the taxpayer benefits. H.R. 4210, by applying this principle to all intangible assets, will unquestionably enhance the matching of revenues and expenses.

The second policy issue raised by the GAO, lessening the administrative burden on the taxpayer and the IRS, is likewise advanced by H.R. 4210. The statutory recovery period and method are clear under H.R. 4210. Current tax law governing intangible assets requires businesses and the IRS to make decisions based on speculative results of tax litigation and differing decisions of the various courts. The current judicial status of the Newark Morning Ledger Co. and Tele-Communications, Inc. cases emphasizes the uncertainties to which both the IRS and taxpayers are subject. H.R. 3035, as originally drafted, excluded certain government licenses from the legislation's amortization provisions, ensuring ongoing litigation and controversy.

In summary, the inclusion of renewable government licenses in the intangible asset amortization provisions will help ensure an improved matching of business expenses with the related revenue. It also avoids the detrimental and economically wasteful litigation and controversy currently experienced. In addition, such inclusion strongly promotes the overall goals of tax policy; equity, certainty and economic efficiency.

Houston Industries Incorporated urges continued emphasis on intangible asset tax treatment simplification, but only in a manner equitable to holders of government licenses. To ignore the economic realities in the taxation of this substantial group of taxpayers would severely jeopardize the results sought from such sound legislation.

Statement of the Independent Insurance Agents of America

Mr. Chairman and members of the committee, my name is Eric Gustafson. I am Chairman of the Blake Insurance Agency in Portsmouth, New Hampshire, and I am President-Elect of the Independent Insurance Agents of America (IIAA). I am pleased to submit this testimony today on behalf of the Independent Insurance Agents of America, which represents over 220,000 independent agents. The IIAA appreciates the opportunity to submit testimony today on the tax treatment of intangible assets.

My insurance agency, which has 25 associates, is a typical independent agency. While there are very large agencies and brokerage firms, most independent insurance agencies are small businesses that employ fewer than 10 individuals. Many are, quite literally, Mom and Pop enterprises run by one family.

Independent agencies are service-based businesses. Their stock in trade is their customers. That is why insurance agents have traditionally guarded the ownership of insurance expirations so closely. This point can't be overemphasized. Most customer lists are owned by the company that creates a product. For example, a newspaper, which sells newspapers, owns its customer list and a bank, which takes deposits, owns its depositor list. But independent insurance agencies—and not the companies that underwrite insurance—own the customer list. That principle is what gives independent insurance agents their value and preserves their independence.

In essence, the value of an agency is determined by the number and type of its client relationships, which together constitute its expiration list. The expiration lists provide the information needed to retain customers for renewals and market new products to old customers. For this reason, the amortization of intangibles is an issue of critical importance to independent agents.

That is why we are particularly appreciative of the efforts of Senators Tom Daschle and Steve Symms, the original sponsors of S. 1245. That bill, which has attracted 19 co-sponsors, would instruct the IRS to conform to the established principles of law which permit the amortization of intangible assets.

Ways and Means Committee Chairman Dan Rostenkowski has taken a different approach. By recognizing the value of intangible assets, by abolishing the need to distinguish between intangibles and goodwill, and by applying a consistent method and rate of depreciation, the legislation brings certainty to an issue that has long been the subject of disputes, time-consuming investigations, and costly litigation. In our view, this legislation represents a solution beneficial to both the Internal Revenue Service and insurance agents.

We do note, however, the need to find a resolution for transactions that are not covered by H.R. 3035, as originally introduced.

Insurance agents are now battling with IRS agents over the treatment of past tax years. Any legislation that puts this issue to rest should eliminate, as well, litigation and uncertainty surrounding the continuing effects of past transactions. Some concerns have been raised with respect to the appropriateness of including with any intangibles legislation enacted, provisions which apply to assets acquired prior to the effective date of the legislation. This issue has in some cases been referred to as the "retroactivity" issue. We believe that this characterization of the issue and the concerns that have been raised with respect to it, are misplaced. Moreover, we strongly believe that in light of the Internal Revenue Service's position in this matter, and the substantial matter of controversies pending in this area, that it is highly appropriate and desirable for the Congress to provide some remedial provisions with respect to assets acquired prior to date of enactment. The following points support this conclusion.

First, the retroactivity that exists in the current situation is a consequence of the Internal Revenue Service's Coordinated Issue Paper which was issued sometime in February of 1990. Under that Coordinated Issue Paper, the Internal Revenue Service has taken a position that customer-based intangibles acquired are per se non-amortisable as a matter of law. The Coordinated Issue Paper substantially changed the pattern and practice of the Internal Revenue Service in this area in a manner that retroactively affected assets of taxpayers acquired in previous transactions. Moreover, the position of the Internal Revenue Service is wholly inconsistent with the reasonable expectations which taxpayers had when they acquired these assets.

Second, the normal concerns with respect to retroactivity from a tax policy perspective do not apply in this case. There is no windfall that taxpayers will experience to the extent that provisions applicable to previously acquired assets simply provide them with the expectation that they had at the time of the acquisition, i.e., that the assets would be amortizable over their useful life if the taxpayer could demonstrate the fair market value.

Third, the controversy over the 17-year provision contained in the recently passed tax bill, H.R. 4210, the "Tax Fairness and Economic Growth Act of 1992," is a consequence of the fact that the provision would permit amortization of goodwill. However, the recovery period that would be permitted for goodwill and other intangibles of 17 years is substantially longer than the average period claimed with respect to the intangible assets alone. In fact, many taxpayers who would choose the 17-year provision would experience a net tax penalty even though they would be permitted to mortise goodwill. This phenomenon, inconsistent with the normal adverse selection analysis that would suggest that taxpayers would only elect the 17-year provision if it provided them with a better result than they have claimed on their return, occurs because taxpayers are willing to pay a premium to attain certainty and to avoid the cost of addressing a controversy with the Internal Revenue Service. These costs can sometimes be substantial involving lawyers, accountants, and valuation experts. Finally, it is abundantly clear that there is a crying need to provide a legislative solution to a substantial number of controversies that are currently pending between the Internal Revenue Service and taxpayers. The brief submitted by the Solicitor General in the *Newark Morning Case,* currently pending in the Supreme Court, clearly makes this point. While the Solicitor General supported the Third Circuit, he nevertheless supported the petition for writ of certiorari by the taxpayer by observing, in effect, that there is massive confusion as to the current state of the law.

> "We agree with petitioner, however, that this case involves a recurring issue of substantial administrative importance given rise to inconsistent reasoning and inconsistent decisions among the Circuits. We therefore do not oppose the granting of certiorari in this case."

It is difficult to understand how anyone could argue that a clarification of the law in a manner intended to resolve expeditiously controversies between taxpayers and the Federal government on a reasonable basis should be considered retroactive in a climate where even the governments represented admit that the current state of the law is thoroughly confusing. For these reasons, some clarification of the law with respect to previously acquired assets should be included with any legislation enacted in this area to encourage the fair and expeditious settlement of controversies.

For independent agents, resolution of the intangibles issue is particularly timely because the insurance industry is in a state of flux. During the four-year period of 1986 through 1989, one in four agencies was involved in an agency merger. The large number of mergers is due in part to the changing face of the insurance marketplace, and more recently, to the recession. Agencies have been compelled to merge for a more efficient and profitable operation.

In the buying and selling of insurance agencies, the expiration list is generally the largest item of value. The expiration list gives the owner the detailed information to retain and expand sales to an existing customer. It represents a stream of expected income for the owner. We are seeing standard and accepted operating procedures for the amortization of intangibles under siege by the IRS and subject to inconsistent court rulings. This uncertainty negatively effects the value of all independent insurance agencies.

The effect of the IRS's Coordinated Issue Paper on independent agencies has meant unexpected and unnecessary losses for agents who, because of market conditions or their own personal needs, must sell their business. It adversely affects the borrowing power of an agency, particularly if the value of the agency fluctuates with every IRS pronouncement and every court ruling.

Clearly, the IRS is wrong in its contention that most intangible assets are indistinguishable from goodwill and going concern value. Expirations are bought and sold because they offer clear-cut, immediate opportunities for development of new business in addition to the renewal or continuation of existing policies. The purchase price of an agency reflects directly the size and quality of its expiration list. This is particularly clear for independent agencies which have few other assets to sell.

It is also clear that expirations have a determinable useful life. The information purchased in an expiration list declines in value as policy holders on the list cease to be customers and no longer generate commission income for the taxpayer. Eventually, once all of the policy holders cease to be customers, the information purchased by the other agency will be of merely historic value.

Industry appraisers regularly follow established accounting guidelines to determine with reasonable accuracy an expiration's useful life. This is based on such factors as the kinds of policies included in the list and the renewal history of those policies. Most purchasing agencies spend considerable time and resources to calculate an expiration list's useful life upon purchase. In my experience, most agencies calculate a useful life of five to seven years.

The Coordinated Issue Paper exacerbates what is already a discriminatory tax policy against buyers and sellers of intangibles assets. Under present law, advertising and other expenses associated with the creation of a customer base are deductible as ordinary and necessary business expenses. A purchased customer base is treated differently, though, and must be mortised over several years. Current IRS policy which completely denies amortization of customer based intangibles adds further discrimination and depresses the purchase price.

Failure to permit amortization also results in overtaxing the purchaser of the list on income generated by the asset during its useful life. A fundamental principle of the federal tax law is that income from the taxpayer's business activities is taxed on a net, and not a gross, basis. Any proposal that denies on a per se basis amortization of the cost of insurance expiration lists violates this fundamental principle of federal tax law.

Chairman Rostenkowski's legislation would restore much of the value of expirations by guaranteeing their amortization over a fixed period. The IIAA supports both the Daschle/Symms bill and H.R. 3035, which are different, but reasonable approaches that we believe should be acceptable to all parties. Should the Committee decide that a standardized recovery period is the preferable route to follow, we hope that it would cover both present and future tax treatment of intangibles.

Although we believe the 14-year amortization period does not accurately reflect the actual useful life of expirations, we understand and appreciate the need for the legislation to be revenue neutral. Should this Committee decide to adopt a 14 year (or another uniform) recovery period, we urge the Committee not to permit any exceptions to the legislation for two reasons. First, once industry-specific calculations are made, fairness would require that the useful life for all other industries, includ-

ing insurance, also be re-calculated to better approximate our real experience. Second, because the 14-year period is designed to be revenue-neutral, we fear that any exceptions might lead some to argue that the 14-year period should be increased for the rest of us. That, we would vehemently oppose.

We encourage the passage of intangibles legislation and stand ready to provide the committee with any information which may assist its efforts.

STATEMENT OF THE MASSACHUSETTS COMPUTER SOFTWARE COUNCIL, INC.

The Massachusetts Computer Software Council, Inc. (the Software Council) appreciates the opportunity to provide comments for the record with respect to the Senate Finance Committee's consideration of legislation intended to simplify and clarify the tax treatment of acquired intangible assets. The Software Council has been actively involved in the debate over this legislation since House Ways and Means Committee Chairman Dan Rostenkowski (D–IL) introduced his original intangibles bill (H.R. 3035), and looks forward to continuing to work with the Committee and its staff in the future to provide information as to the impact potential legislative changes relating to intangibles would have on the software industry.

There are more than 1,400 software companies in the Commonwealth, employing 46,000 people and generating more than $2 billion in revenue. Software is one of the fastest growing industries in Massachusetts, with a projected rate of growth of 24 percent in 1992. While the Software Council's membership includes large household names, the majority of our members are small, entrepreneurial software companies that play a vital role in developing new software technologies and in creating new, high-skilled jobs essential to the recovery of the Massachusetts economy. Of the 1,400 software companies in Massachusetts:

—74 percent have 25 or fewer employees
—77 percent have revenues of $5 million or less
—76 percent were established after 1980
—89 percent are privately held
—77 percent are self financed, and
—48 percent have distribution outside the United States.

Your committee, as well as Chairman Rostenkowski, must be commended for addressing an area of the tax law that needs clarification and certainty. In addition, the Software Council recognizes that changes that have been made to H.R. 3035 as part of its inclusion in H.R. 4210, the economic growth legislation vetoed by President Bush, go a long way towards responding to the concerns of the software industry. Still, the Software Council believes the scope of the legislation as it currently stands remains too broad, and urges the committee to exclude all computer software acquisitions from the provisions of the intangibles legislation, thus allowing the industry to retain sound current-law tax principles that have worked well for more than 20 years.

As introduced, H.R. 3035 would have required a 14-year amortization period for purchases of commercially available software products, discrete purchases of software technology, and acquisitions of software technology as part of the purchase of a trade or business. When compared to the current-law amortization period of five years or less as provided under Rev. Proc. 69–21, the 14-year amortization period would have increased the after-tax cost of acquired software by approximately 12–20 percent.

Since the introduction of H.R. 3035 in July 1991, the Software Council worked with the Massachusetts House and Senate delegations, as well as the House and Senate tax committee members id staff, requesting that the current-law tax treatment of software be retained.

In the final version of H.R. 4210, the House and Senate responded to many of the Software Council's concerns. H.R. 4210 excluded acquisitions of commercially available software products, regardless of whether acquired on a stand-alone basis or as part of a trade or business acquisition, and also excluded certain acquisitions of software technology from the general 14-year-amortization rule of the bill.

Still, the Software Council believes that, in general, acquisitions of computer software should not be affected by this legislation.

Specifically, the Software Council believes that many software technology acquisitions are structured a trade or business acquisitions for valid, non-tax purposes and that these acquisitions should also be excepted from the 14-year amortization provisions of the intangibles legislation.

Acquisitions of software products and software technology are critical to the continued success of the U.S. software industry. Small entrepreneurial software compa-

nies create many new and exciting technologies which they are often unable to successfully bring to market. Because software products are becoming more complex and multi-functional, many of the larger, more established software companies must look outside their own development organizations to acquire the specialized software technologies they need to add to their core products to satisfy customer demand for new features and greater performance.

For example, software companies that developed successful spreadsheet and word processing programs did not necessarily have the in-house development expertise to write the graphical user interface (GUI) code required for these products to function effectively in the popular Windows operating environment. One of the Software Council's members, Lotus Development Corporation, acquired its GUI technology by acquiring Samna Corporation, a small software company struggling to penetrate the word processing market. Lotus acquired the GUI technology it needed and Samna's word processing products gained market access through Lotus' distribution channels. Both the small entrepreneur and the large software company benefit from these technology acquisition transactions.

Because acquisitions of software technology are often a preferable alternative to developing technology inhouse, the Software Council believes that the definition of a trade or business acquisition utilized in the legislation is important.

Compared to H.R. 3035 as introduced, H.R. 4210 contained a number of significant modifications regarding the definition of a trade or business that are helpful in distinguishing certain technology acquisitions. The reference in H.R. 4210 to the code section 1060 trade or business definition is helpful because it clarifies the scope of this exclusion by indicating that an asset or group of assets to which goodwill would not attach should be excluded from the trade or business acquisition rules. The separate acquisition of computer software is not the type of acquisition to which goodwill would generally attach.

The clarification in H.R. 4210 that the value of assets acquired by a transferee relative to the value of the assets retained by a transferor will not be determinative of whether the transferee has acquired a trade or business is also helpful. An acquisition of a portion of a group of assets not constituting a trade or business should not be treated as a trade or business acquisition, even if a high proportion of assets is acquired.

The Software Council is concerned, however, about suggestions that the existence of a continuation of employment relationships as part of a transfer of assets will assist in determining whether that transfer of assets constitutes the acquisition of a trade or business or a substantial portion thereof. When acquiring software technology, it is often imperative that the transferee continue to have access to the skills of the individual or individuals most knowledgeable about the technology. This is not indicative of the existence of any type of goodwill or going concern value, but is instead a necessary element in efficiently confronting the myriad technical problems that may be anticipated when assimilating the new technology.

The Software Council believes that computer software may be excluded from the intangibles simplification legislation without undermining the primary policy objectives of the legislation—to eliminate valuation and allocation controversies between taxpayers id the Internal Revenue Service.

Computer software does not create the significant intangible identification, valuation, and amortization issues which the legislation is designed to resolve. Rev. Proc. 69–21 has provided a workable definition of computer software which has been used by the industry and the Internal Revenue Service for 23 years. Just as the current version of the legislation recognizes that computer software products are commercially available and can be easily valued, discrete software technology acquisitions can be valued by reference to the contract.

In addition, software technology acquisitions which are structured as trade or business acquisitions generally do not create significant identification and valuation issues because they most commonly involve the acquisition of small, young software companies with only a few employees. The recent GAO study on intangible amortization controversies, *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, reported that technology-based intangibles, of which computer software is only a subset, accounted for less than 10% of the dollar value of taxpayer-IRS disputes that were surveyed. Clearly, the approach provided by Rev. Proc. 69–21 has functioned effectively to minimize controversy regarding the tax amortization of acquired software technology as part of a trade or business acquisition. Small, start-up software companies have little or no goodwill or going concern value; some of these companies have not yet brought any products to market.

The computer software acquired in these transactions is readily identifiable. Software products are tools used to perform work. Software code is specific in form and

function. Because the value of software companies is primarily technology driven and is rarely supported by any significant goodwill and going concern value, allowing a compensating tax deduction for goodwill and going concern value is of little or no value to the software industry.

The changes that were made to the original version of H.R. 3035 recognize that the economic life of software is much less than 14 years; we believe this approach should be extended to all software, regardless of how it is acquired by a taxpayer. The bill provides for a three-year amortization period for computer software excluded from the bill's general 14-year amortization period. As noted above, Rev. Proc. 69–21 currently provides that computer software may be amortized over a period of 60 months or less. During the 1980s, computer software was generally revised and upgraded every 2–3 years. Currently, rapid changes in computer hardware, operating system software, and customer demand for increased features and performance have reduced the upgrade cycle to 12–18 months.

In conclusion, the Software Council would like to note that it represents an industry that is one of the few in which the United States is considered globally preeminent. Massachusetts companies have led the way in contributing to the continuing leadership and competitive position of the industry. We believe the intangibles simplification legislation currently under consideration by the Senate Finance Committee should not unnecessarily burden the software industry. Therefore, the Massachusetts Computer Software Council, Inc. urges the Committee to exclude all computer software acquisitions from the provisions of the intangibles simplification legislation and allow the industry to retain the current law principles of Rev. Proc. 69–21.

MAYER, BROWN & PLATT,
Washington, DC, May 12, 1992.

Hon. LLOYD BENTSEN, *Chairman,*
Committee on Finance,
U.S. Senate,
205 Dirksen Office Building,
Washington, DC 20510

Re: Simplifying Tax Treatment of Acquired Intangible Assets

Dear Mr. Chairman: This is submitted for the record of the Committee's April 28, 1992, hearing.

SUMMARY OF POSITION

In summary, many of our clients, including Black & Decker Corporation and Brunswick Corporation, strongly support the intangibles legislation recently adopted by Congress in section 4501 of H.R. 4210. The simplification and clarification of the tax treatment of acquired intangible assets are necessary reforms.

Under current law, there is disagreement over when and if various intangible assets can be amortized. Also, because intangibles are often amorphous, even when there is agreement that an intangible may be amortized, determining the value and life of the asset typically produces controversy. These disputes needlessly consume vast public and private resources and clog the administrative and judicial systems.

The recent legislation would have quickly and fairly put an end to most of this controversy because it would have applied to future acquisitions and, *most important,* on an elective basis, to acquisitions made in open taxable years. This open years election is an integral part of any reform which is to be broadly and timely effective.

BACKGROUND

A broad spectrum of businesses (large and small), the Administration, and tax professionals agree that the tax treatment of acquired intangible assets can and must be simplified by legislated reform. Existing law is complicated, uncertain, and unevenly applied. Whatever the Supreme Court decides, these deficiencies will not be readily cured by its decision in Newark *Morning Ledger.*

Taxpayers and the government spend vast sums on and devote countless hours to these disputes. According to the GAO, the number of disputes over intangibles in 1989 exceeded 2,000. Assistant Secretary Fred Goldberg's prepared testimony suggests that each of these disputes consumes an average of 6,000 staff hours and at least $160,000 of out-of-pocket expenses. That is some 12 million staff hours and $320 million in the aggregate, and these numbers do not attempt to quantify the additional burdens on taxpayers or the courts.

BENEFITS OF THE OPEN YEARS ELECTION

H.R. 4210 sought to end quickly and fairly—to the government and taxpayers—these disputes and their attendant burdens and expenses. These laudable objectives, however, will not be fully or readily achieved by new legislation unless the election for resolving controversies arising in open years is retained. Absent the election, these controversies will continue to clog the courts and waste public and private resources. Their ultimate resolution will have little, if any, precedential value, and the significant benefits of reform will be denied for years. Opposition to the election is particularly ironic because purely prospective simplification and reform will leave unresolved the very disputes that drew Congress's attention to this issue.

CRITICISMS OF THE ELECTION ARE UNFOUNDED

Although Congress just adopted the open years election, its critics now argue that: (i) the election is unnecessary because prospective-only legislation will guide the quick settlement of disputes arising from acquisitions prior to enactment; (ii) it bestows a "windfall" on past purchasers of intangible assets; (iii) it unfairly treats taxpayers with closed taxable years; (iv) it favors the larger taxpayers; (v) it cannot be revenue neutral; and (vi) assuming retroactive application is efficacious, it should be made mandatory rather than elective. Each of these criticisms is seriously flawed.

Without specific legislation, a prospective provision cannot, and will not, serve as a model for resolving prior disputes. The questions at the heart of disputes concerning prior acquisitions are what is non-amortizable goodwill and what are the lives and values of other, amortizable intangibles. These issues are not addressed in the proposed legislation and, thus, it could not guide their resolution. (Similarly, these issues are not fully before the Supreme Court in *Newark Morning Ledger.*) In addition, the 14-year composite life is sensible and acceptable only in the context of a compromise in which goodwill is amortizable. Thus, purely prospective reform will not resolve "preenactment" cases.

It is also argued that, because a prospective law will limit the precedential value of ongoing cases, the incentive for the Service and taxpayers to litigate these disputes will diminish and controversies arising from open years will be resolved more readily. This is unrealistic once adversarial positions are taken. It also betrays a misunderstanding of the basic nature of these disputes and understates their importance to the parties notwithstanding a significant change in law. For example, although the investment tax credit was repealed six years ago, dozens of cases involving ITC issues continue to be decided by the courts each year.

Fears that the election will bestow unexpected or "windfall" benefits are misplaced. Were the purpose of the legislation to influence the behavior of those who buy intangibles, the expectations of affected taxpayers would be a legitimate concern. However, the open years election is a simplification initiative which seeks only to eliminate disputes: to do this fully and timely, the legislation must apply to cases arising in open years as well as the future. Moreover, any pro-taxpayer change in the Code, even a purely prospective one, can be said to create a "windfall." In this case, for instance, the law will bestow a currently unavailable benefit on the future buyers and sellers of intangible assets, who will divide that benefit between them. Electing past purchasers will not split their benefit, but the aggregate "windfall" is identical in both cases.

That past purchasers would not share such benefits was part of their bargains struck with the sellers. The purchaser always assumes the benefits and risks of favorable and unfavorable changes in the law (e.g., the repeal of the *General Utilities* doctrine or an increase in tax rates). Moreover, if anyone benefited from the LBOs and acquisitions that gave rise to many of the disputes over intangibles, it was the sellers who received large premiums. Undoubtedly, few would return those premiums now in order to share the benefits of the election.

The election will not treat unfairly taxpayers with closed taxable years. These taxpayers presumably obtained whatever results were acceptable to them under the then circumstances, including most importantly, the strengths and weaknesses of their positions. In particular, given the realities of "hot interest" and penalties, taxpayers with closed years are most likely to be those with the weakest and clearest cases.

In any event, making the election available for closed years does not advance (but is *contra* to) the purposes of the legislation. Because these cases are already closed, their inclusion in an election provision would not achieve any savings in litigation costs or relieve administrative or court dockets. On the contrary, it will generate new and substantial revenue costs (and administrative burdens relating to opening closed years) without providing any corresponding public benefit.

The open years election will not unfairly favor larger taxpayers. The assertion that larger taxpayers will be favored is apparently based on the premise that the Service now audits large corporations every year and that, since audits tend to keep taxable years open, larger corporations generally have more open years. This concern is misplaced. First, taxpayers from all industries favor this election. Second, it is not clear there is a meaningful disparity in size among the taxpayers that have purchased substantial intangible assets. As a consequence, the audit histories of affected taxpayers may not, in fact, vary significantly. Third, to the extent there are differences, they result almost exclusively from the fact it is Service policy to audit virtually every taxable year of large corporations. To characterize that policy as, on balance, bestowing a favor on large entities is folly. Finally, taxpayers with the strongest cases are the most likely to have open taxable years.

An election can be revenue neutral. Taxpayers will make elections when they believe, on balance, that the elections will cost less than their anticipated tax liabilities (with interest) plus their significant dispute-resolution costs. Because these costs are high, and the ultimate resolution of disputes is uncertain at best, substantial numbers of taxpayers will elect to pay a larger tax than they think they would pay if they pursued continued litigation or other administrative resolutions. Taxpayers will pay a premium for certainty and to enable themselves to allocate resources from continuing disputes to other, more productive activities. Moreover, taxpayers will pay these amounts to the government sooner than if they pursued litigation. Thus, both the government and taxpayers benefit.

Revenue estimators are capable of quantifying such anticipated taxpayer behavior. Thus, there is no inherent reason why the election cannot be revenue neutral (or even raise revenue).

Mandatory application, though potentially troublesome, might be acceptable if carefully tailored. It is true that a mandatory provision would eliminate the maximum number of disputes. However, such after-the-fact revisions of the Code can unfairly surprise taxpayers and generally undermine the stability of legitimate private sector expectations. If mandatory application were pursued, the Committee would have to take particular care to avoid (i) undue harm to the most vulnerable taxpayers who relied on prior law and (ii) unnecessary administrative problems for the Service and taxpayers. This might be done, for example, by excluding relatively small acquisitions (e.g., those involving less than $1 million in any taxable year) and transactions in which more than half of the value of the acquired intangibles was attributable to relatively short-lived assets (e.g., lives of less than seven years). These taxpayers should, however, probably be given an option to make the election notwithstanding the exceptions designed for their protection.

We would welcome the opportunity to answer any question you or your staff may have.

Respectfully,

JERRY L. OPPENHEIMER.

STATEMENT OF THE MOTION PICTURE ASSOCIATION OF AMERICA, INC.

The Motion Picture Association of America, Inc. ("MPAA")[1] respectfully offers these comments on recent efforts to simplify the tax treatment of acquired intangible assets. The member companies of the MPAA are leaders in the fields of motion picture production and distribution, television programming and home video entertainment. America's motion picture and television production community is a preeminent exporter of American-made products. Its creations are the most innovative in the world, unrivaled in the international marketplace, and coveted by consumers around the globe. As a result, the industry contributes substantial surpluses to the U.S. balance of trade, and is a substantial taxpayer to the U.S. Treasury.

The MPAA commends the effort to bring simplicity and certainty to a complex and controversial area of federal tax law—the tax treatment of purchasing the intangible assets of a trade or business. The Rostenkowski intangibles bill (H.R. 3035) was designed to simplify the tax treatment of acquired intangibles by providing, generally, that the cost of acquiring most intangible assets are to be amortized ratably over a 14-year period. As introduced, the bill would have covered (among other

[1] The MPAA is a trade association representing the major producers and distributors of theatrical motion pictures, TV programs, and home video material. Its members are: Buena Vista Pictures Distribution, Inc., Columbia Pictures Entertainment, Inc., Orion Pictures Corporation, MGM-Pathe Corporation, Paramount Pictures Corporation, Twentieth Century Fox Film Corporation, Universal City Studios, Inc., and Warner Bros., Inc.

things) the portion of the cost of acquiring films, videotapes and sound recordings attributable to the intangible value thereof.

The MPAA was concerned about the bill's impact on films that are purchased, or films for which the distribution rights are purchased. Under the bill as introduced, purchased films and purchased film distribution rights would have been treated as intangible property—and would not have been subject to depreciation under the income forecast method, the depreciation method normally used for films. On the other hand, films that the taxpayer produces for itself would continue to be depreciated under the income forecast method.

The MPAA believes that such a distinction in the depreciation of films makes no sense. The MPAA worked with members of the Ways and Means and Finance Committees to address this problem. As a result, the intangibles provisions adopted by the House and Senate in H.R. 4210 stated that interests in films, sound recordings or videotapes are specifically excluded from the definition of a "section 197 intangible" if such interests were not acquired as part of the purchase of a trade or business. The MPAA believes that H.R. 4210, as finally enacted by the House and Senate, provides reasonable treatment for motion picture and television films and interests therein.

I. THE FILM INDUSTRY AND CURRENT TAX LAW RULES

Motion picture and television films are produced and distributed in many different ways. Some films are produced and distributed entirely in-house. In some cases, a studio will acquire the distribution rights to a completed film. In other cases, a studio may acquire the distribution rights to a film to be produced in the future. Some producers transfer limited exhibition rights (e.g., video cassette rights, cable television rights, or foreign theatrical distribution rights) to other distributors.

There are numerous variations of these different production/distribution agreements. The form that these agreements take is not determined by tax considerations, but rather is determined by industry practices that vary from studio to studio.

Over time, tax law rules have evolved that properly measure the taxable income derived from these myriad types of production and distribution agreements. Under these rules, the motion picture and television film production industry, and the film distribution industry, use the income forecast method to calculate the depreciation of production or acquisition costs of films and film distribution rights. The income forecast method is also used for financial accounting purposes.

Under the income forecast method, the depreciation of films and film rights is based on the annual flow of income from the film or film rights. The portion of the capitalized costs of producing or acquiring such property that is deducted each year as depreciation is based on a fraction equal to the income earned by the taxpayer for that year from the film or film rights divided by the total amount of income that it is estimated the taxpayer will earn from the film or films rights.

The Internal Revenue Service and the courts recognize that the income forecast method is the most appropriate method of depreciating films and film rights because of the uneven flow of income from such assets and because the useful life of such assets is best measured by the flow of income rather than an estimated useful life based upon the passage of time. As the Internal Revenue Service has recognized, the traditional methods of depreciation are inadequate, and result in a distortion of income, when applied to assets such as films and film rights. It is for the same reasons that use of the income forecast method is required for financial accounting purposes under FASB rule 53. Thus, in Revenue Ruling 60–358, 1960–2 C.B. 60, the Internal Revenue Service approved the use of the income forecast method as the best method to be used by producers of television films. In Revenue Ruling 64–273, 1964–2 C.B. 62, the Internal Revenue Service approved the use of the income forecast method as the best method to be used by producers of motion picture films.

The income forecast method is based on the same principle as the units-of-production method, which measures the depreciation of machinery and equipment according to the uneven rate at which the property is used. The same principle is the basis for the allowance of cost depletion deductions. Thus, the income forecast method is not an "accelerated" method of depreciation or a "special" tax benefit for the motion picture industry. Rather, the income forecast method is a depreciation method comparable to other depreciation methods used to calculate depreciation for tangible property. What distinguishes the income forecast method is that no other method accurately measures the economic depreciation of motion picture and television films.

The income forecast method is used to calculate depreciation not only for the cost of producing or purchasing films, but also for the costs of acquiring exhibition

rights, distribution rights, and contract rights to income from a film, because the recovery of such capital costs is tied directly to the uneven flow of income from the film or the film rights. The useful life of such property and property rights is best measured by the flow of income rather than the passage of time. Thus, in Revenue Ruling 77–125, 1977–1 C.B. 130, the Internal Revenue Service approved the use of the income forecast method as the best method for depreciating the cost of a contract right to income from a film received by a producer as compensation for producing the film. In Revenue Ruling 74–358, 1974–2 C.B. 43, the Internal Revenue Service approved the use of the income forecast method for depreciating a television station's costs of acquiring limited rights to exhibit films.

Under present law, the income forecast method of depreciation permits each party involved in the production or distribution of a film to depreciate his capital investment in a way that matches depreciation expense with the uneven flow of income from his interest in the film. Thus, the present Federal income tax treatment of motion picture and television films provides simplicity, certainty, and fairness.

II. THE PURPOSE OF H.R. 3035 AND H.R. 4210

H.R. 3035 and the intangibles provisions in H.R. 4210. were designed to eliminate the uncertainty and complexity surrounding the tax treatment of purchased intangible assets. This complexity and controversy has its origin in the difficult problem of distinguishing between the purchase of depreciable assets and the purchase of nondepreciable goodwill and going concern value, when an entire trade or business is purchased.

Intangible assets with an indefinite useful life such as goodwill and going concern value may not be depreciated or amortized. Other intangible assets that are separately identifiable and that have a limited economic life may, like tangible business assets, be amortized or depreciated. Disputes arise in connection with the acquisition of a trade or business when taxpayers take the position that they have purchased certain separate intangible assets that the Internal Revenue Service alleges are similar to, or are components of, goodwill or going concern value (*e.g.*, customer lists, assembled workforce, core deposits, and the like). Taxpayers have claimed that such assets are amortizable assets that are separate and distinct from goodwill and going concern value.

The Internal Revenue Service has challenged taxpayers' attempts to amortize these types of intangible assets on several grounds. The Internal Revenue Service has argued that these assets were simply components of nondepreciable goodwill or going concern value, particularly where the value of the assets was based on the expectation of continued customer patronage. The Internal Revenue Service has also argued that these assets were nondepreciable because they are "regenerated" or maintained through the normal operation of the taxpayer's business, giving the assets an indeterminate useful life. In addition, the Internal Revenue Service has argued that the costs of maintaining or regenerating these assets (*e.g.*, the costs of advertising, entertaining customers, promotions, and employee training) would be currently deducted by the taxpayers as ordinary and necessary business expenses, thereby giving rise to double deductions—one deduction for amortizing the asset and a second deduction for the costs of maintaining or regenerating the asset.

These many disputes between taxpayers and the Internal Revenue Service concerning the proper treatment of intangible assets have spawned considerable litigation. Resolving these controversies is often a very costly and time consuming endeavor for both the taxpayer and the Internal Revenue Service, as well as the courts. Moreover, this litigation has produced inconsistent results, with both taxpayers and the Internal Revenue Service winning important victories. Although the courts in many early cases upheld the Internal Revenue Service's position in these disputes, court cases and rulings began in the 1960s to treat these controversies as essentially factual disputes. The uneven results of this litigation have come about not only because of the different factual circumstances of each case, but also because courts disagree as to the nature of the intangible assets that taxpayers have sought to depreciate. By providing a single rule for the amortization of almost all acquired intangibles in the nature of goodwill and going concern value, H.R. 3035 and the intangibles provisions of H.R. 4210 commendably sought to end the controversy once and for all.

III. APPLICATION OF THE INTANGIBLES PROVISIONS OF H.R. 4210 TO FILMS AND FILM RIGHTS

As finally enacted by the House and Senate, H.R. 4210 specified a single 14-year amortization period for recovering the cost of most acquired intangible assets, including goodwill and going concern value. Generally, this rule applied to the acquisi-

tion of an intangible asset whether the asset was acquired as part of a trade or business or was acquired separately as a single, pre-existing asset.

The 14-year amortization rule applied to all acquired intangible assets other than those specifically excluded. As finally enacted by the House and Senate, H.R. 4210 specifically excluded interests in films, videotapes, sound recordings and similar property, if such interests were not acquired as part of the purchase of a trade or business or the purchase of a substantial portion thereof. Unfortunately, there was no exclusion for such interests when they were acquired as a part of a trade or business. Also excluded were, for example, patents and copyrights not acquired in a trade or business purchase, sports franchises, and commercial computer software.

IV. THE TREATMENT OF FILMS AND FILM RIGHTS UNDER H.R. 4210

The provision in H.R. 4210 that excludes interests in films, videotapes, sound recordings, and similar property from the 14-year amortization rule, if such interests were not acquired as part of the purchase of a trade or business, is fully consistent with, in fact is required by, the goals of tax simplification and tax fairness.

The goal of simplifying the tax treatment of purchased intangibles is to eliminate legal and factual disputes relating to the existence of intangible assets, the life of such assets, and the portion of the purchase price for a trade or business that is allocable to such assets. These disputes between taxpayers and the Internal Revenue Service relate to intangible assets such as customer lists, subscription lists, core deposits, and customer base, which are difficult to distinguish from nondepreciable goodwill and/or going concern value.

Films and film rights are acquired by taxpayers in the usual course of their trades or businesses. A film distributor acquires film distribution rights in a film. A film producer acquires the film right to a book or screenplay. These are normal, everyday transactions that do not involve the acquisition of the goodwill or going concern value of a trade or business. There is no dispute that the proper method of depreciating such films and film rights is the income forecast method of depreciation, which has long been acknowledged by the Internal Revenue Service as the method that best measures the depreciation of such property. Thus, these purchases of films and film rights share none of the characteristics of the intangible asset purchases that have been a source of controversy between taxpayers and the Internal Revenue Service.

In addition, requiring 14-year amortization for films and film rights purchased in normal commercial transactions would create an arbitrary and pointless distinction between films that are created by the taxpayer and films or film rights that are purchased by the taxpayer. Under current law, the costs of both creating and purchasing films are treated exactly the same, i.e., such costs are required to be capitalized and recovered through depreciation. Creating a distinction between "created" films and "purchased" films would make no sense, would create new controversies between taxpayers and the Internal Revenue Service, and would disrupt normal business practices in the motion picture and television film industry. Such a distinction would produce different tax treatments for different forms of normal commercial transactions, resulting in the elevation of form over substance. A distinction between acquired and created intangibles makes sense only as applied to goodwill, going concern value, and similar assets (e.g., customer lists, core deposits, subscription lists, insurance expirations and the like) because current law already provides different treatment for the costs of creating such assets, which are currently deductible, and the costs of purchasing such assets, which must be capitalized.

Finally, it should be noted that the proper tax treatment of the costs of purchasing motion picture films has been discussed in a recent report of the Congressional Research Service. (Jane G. Gravelle and Jack Taylor, "Taxing Intangibles: An Economic Analysis," October 25, 1991.) That report concludes that a uniform amortization period for the costs of purchasing intangible assets such as goodwill, going concern value, customer lists, and core deposits is consistent with the goals of administrative simplicity and tax fairness. The premise for this conclusion is that the costs of creating such assets will continue to be eligible for expensing. On the other hand, the report states that for assets such as motion picture films, for which the costs of production must be capitalized, the proper measurement of income from such assets requires that the purchase costs be depreciated over the useful life of each individual asset. Thus, according to the Congressional Research Service report, the economic and tax policy rationales for providing a single amortization period for purchased intangible assets do not apply to motion picture and television films.

V. CONCLUSION

The provisions of H.R. 4210 relating to intangibles, as finally enacted by the House and Senate, would be an advancement in promoting tax simplification and providing certainty in the tax law. In preserving the existing tax treatment for interests in films that are not acquired as part of the purchase of a trade or business, the provisions H.R. 4210 avoid the creation of new complexities and controversies, and avoid the disruption of the normal business practices of the motion picture and television film industry. The MPAA strongly recommends that the tax treatment of films and film rights that are contained in H.R. 4210 be preserved in any legislation that simplifies the tax treatment of purchased intangible property.

STATEMENT OF THE NATIONAL ASSOCIATION OF CASUALTY AND SURETY AGENTS

Mr. Chairman, as a member of the Amortization of Intangibles Task Force, NACSA fully supports the earlier testimony of Ken Kies on behalf of this coalition of insurance producers. We are pleased to express our enthusiastic backing of the provisions within H.R. 4021 which—once and for all—would end the controversy over the appropriate treatment of insurance expirations and other intangible assets. This approach of adopting a rule permitting the amortization of both goodwill and intangible assets over 14 years is simple, fair, and good public policy.

The conference tax report, of course, includes an approach toward intangibles taxation that is very similar to Rep. Dan Rostenkowski's intangibles bill, H.R. 3035. Although it was subsequently vetoed by the President for other, unrelated reasons, the bill provided for a 14-year recovery period on all intangibles—including goodwill, and an elective 17-year recovery period for transactions involving intangibles in open tax years. Given the IRS's recent hard-line approach in denying all insurance expiration list amortization, we strongly back this approach.

In my testimony, I would like to emphasize just one of the virtues of this language: it eliminates the unnecessary burden placed on both the IRS and upon insurance agencies by the lack of certainty in the meaning and administration of current law.

The lack of certainty is both legal and factual. *First* as the decision in the *Newark Morning Ledger* case demonstrates, courts disagree on the basic legal rules to be applied. Taxpayers are continually battling to establish a simple legal rule: that the mere presence of goodwill does not bar a taxpayer from establishing the independent value and existence of an intangible asset. Although many courts have agreed with us, the IRS continues to disagree. That means more and more costly litigation.

Second, the establishment of a limited useful life for insurance expirations lists necessarily involves a time-consuming and extremely detailed review of facts. The need to make a specific factual showing thus consumes both IRS and taxpayer resources.

We believe that the language included in H.R. 4021 offers a better path.

Ambiguity and uncertainty are the enemies of fair tax administration. Legal uncertainty means that both the government and taxpayers spend many years and a lot of money re-arguing the same issues over and over again. It's very difficult to run a business if the tax laws governing a basic transaction change in unpredictable and unanticipated ways. Indeed, lack of legal certainty may mean that similarly-situated taxpayers will not be treated the same. That's not fair.

If this legislation were enacted, the legal standard would be settled. The present dispute over the separation of goodwill from intangible assets would end.

Factual uncertainty is burdensome as well. Before an agency sale is consummated, our association's members spend weeks auditing each policy on the expirations list. An IRS agent may spend weeks reviewing that work. Then, if the IRS disagrees, we are required to hire lawyers and possibly outside experts to convince that agency, or even the courts, that we are right. Of course, as the controversy moves through the administrative and legal process, the IRS has to devote its own resources to the same battle.

It's a waste of time. Experience with the depreciation of tangible assets demonstrates the better way: a mandatory schedule establishing a mandatory useful life.

The intangibles provisions of this bill propose a 14-year amortization period for intangible assets. Frankly, our experience suggests that the average useful life of such a list is closer to five or seven years for commercial insurance policies. But we support this legislation because we believe so strongly that IRS and taxpayer resources can both be put to better uses once an understandable rule is enacted. This approach offers the incentive of eliminating the "middlemen," that is, the lawyers,

accountants and valuation experts who add significant costs to the current confusing system.

We also hope that this Committee will clarify the existing law, as it will be applied to transactions that precede the effective date of this legislative package. We have worked hard to apply the same principle embedded in this legislation: that intangible assets are amortizable. Both the IRS and insurance agencies would be best served by eliminating the need to continue to debate whether we are right.

Throughout the process of this legislation and the emerging IRS crackdown on insurance producers' amortization of renewal lists, no one has argued that such lists aren't the core asset of an insurance agency. No one has testified before a committee of either Chamber of Congress that insurance agencies shouldn't be afforded an opportunity to depreciate the proper wasting lifespan of those lists. Indeed, Mr. Chairman, our insurance agent community remembers with appreciation the role you played in 1987 in preserving this crucial business practice. Everyone, it seems, agrees today that the current system is confusing, outdated and in need of overhaul and simplification.

In that light, we could not agree with you more that intangibles reform must not be a vehicle for abuse. We are alarmed at reports that some big companies involved in takeovers in the 1980s could retroactively, and unfairly, benefit from provisions embodied in H.R. 4021. We believe these concerns can be addressed, however. Senator Danforth, for example, has suggested that taxpayers electing the 17-year period be prohibited from claiming refunds. We would support that proposal in an effort to eliminate controversies. We hope that the Committee would find a way to address these concerns satisfactorily. In short, don't throw the baby out with the bathwater.

We strongly urge you to include the intangibles provisions in any future tax legislation that is considered by the Senate. We believe that this solution offers the best way out of the legal haze that now surrounds the treatment of intangible assets. We hope that it will be speedily enacted into law.

Thank you again for this opportunity to express our views.

Statement of the National Association of Enrolled Agents

INTRODUCTION

Good morning (afternoon). My name is Sandy Rosenthal. I am an Enrolled Agent—an Income Tax Professional. As an independent practitioner, I am here today representing the 7,500 Enrolled Agent members of the National Association of Enrolled Agents. Enrolled Agents are taxpayers' representatives and are the only professionals who are trained and tested specifically in taxes. Our membership comprises tax practitioners who deal with many of our nation's small businesses. It is the concerns of these small businesses that I will address today. Our typical business client has less than four employees and gross income of a few hundred thousand dollars to less than a million dollars. By most standards these would be considered very small businesses, yet this segment of our nation's taxpaying community comprises a very significant part of our economy. As a group, small business has been ignored on the impact of the issues which are addressed by this legislation.

Summary of Recommendations

H.R. 3035 has the potential to be a landmark in both simplification and fairness for one of the most contested and controversial parts of the Internal Revenue Code. As both taxpayers and tax professionals, we commend you for your initiative in addressing this issue.

Our recommendations deal with the issues of Small Business, Intangible Assets with Identifiable Useful Lives, Writeoff of Worthless Assets, and Retroactivity. Small business has been overlooked on this legislation. Goodwill has been inappropriately blended with other intangible assets that have clearly identifiable or determinable lives. Addressing retroactivity could bring an end to so much unnecessary litigation over this issue.

Impact of Amortization of Intangible Assets on Small Business

Many small businesses are bought and sold. The typical purchaser of a small business is not a sophisticated businessman. More often than not, an individual has a dream of becoming self-employed but is either not capable of building a business or does not have the time or inclination. That person will buy a business with the assumption that someone else has already acquired all the necessary equipment and other assets, and has made available all of the resources that will allow the purchaser of the business to takeover a "turnkey" operation.

A small business has a "Going Concern Value" that is invariably related to the competency and personality of individuals who made the business successful. After these individuals have departed from the business, the value of the business will rapidly deteriorate unless the new owner solicits new customers and maintains the confidence of the previous customers. After just a few years, the business' customers won't even remember the previous owners and will patronize the business entirely due to the competency, reputation, or advertising of the new owners.

SEC. 197(a) GENERAL RULE

Useful Life of Goodwill for a Small Business

The useful life of goodwill to a small business is short-lived and is not as long as 14 years. Goodwill of a small business is an issue that needs to be dealt with separately from goodwill in general. It is recommended that goodwill for a small business be a graduated amount based upon the cost of the goodwill. The following useful lives for goodwill are recommended based upon the cost of goodwill:

Cost of Goodwill	Useful Life
$50,000 or less	5 years
$50,001 to $100,000	7 years
Over $100,000	14 years

SEC. 197(d) SECTION 197 INTANGIBLES

Intangible Assets with Identifiable Lives

When an intangible asset has an identifiable or determinable life, this life should continue to be used for amortization or depreciation purposes. It would be unfair if intangible assets with identifiable lives are combined with goodwill to establish a single life for all intangible assets. Amortization of a covenant not to compete which is for a three-year period should be over a three-year period not a 14-year period as the legislation prescribes.

If the prerequisite that H.R. 3035 be revenue neutral for a specific period is an absolute necessity, then assets described in Sections 197(d)(1)(C) through 197(d)(1)(F) that are acquired after this period should be allowed to be amortized over their identifiable or determinable lives, when such a life exists.

SEC. 197(e) SPECIAL RULES

Worthless Assets

Section 197(e)(1)(A) prescribes that no loss shall be recognized should one Section 197 asset become worthless so long as any other Section 197 asset acquired in the same acquisition is retained. If an asset is worthless, it should be written off. It's subterfuge to inflate the value of another asset as Section 197(e)(1)(B) requires should a Section 197 asset become worthless. Section 197(e)(1) should be deleted.

If the prerequisite that H.R. 3035 be revenue neutral for a specific period is an absolute necessity, then the provisions of Section 197(e)(1) should terminate at the conclusion of this period.

H.R. 3035—EFFECTIVE DATE

Retroactivity of Legislation

Considerable litigation has occurred which would be resolved for both ongoing and pending cases upon enactment of this bill. To enable this litigation and related cases to be resolved quickly and equitably, it is recommended that this legislation be made retroactive to open tax years.

Alternative Method of Retroactivity

Should the revenue impact of retroactivity become such a substantial issue that it might jeopardize the passage of H.R. 3035, a phase-in method is suggested as an alternative. The phase-in is suggested to occur in the year of enactment to include all goodwill which has been purchased during the three years prior to year of enactment. With the alternative method of retroactivity, all amortization would commence in the year of enactment with a different phase-in amortization period for those goodwill purchases which occurred during the three years prior to enactment.

The following table presents the method for establishing useful life with this concept:

Year of Goodwill Purchase	Cost of Goodwill	Useful Life
Year of Enactment or Later	over $100,000	14 years
1 Year before Enactment	over $100,000	13 years
2 Years before Enactment	over $100,000	12 years
3 Years before Enactment	over $100,000	11 years
Year of Enactment or Later	$50,001 to $100,000	7 years
1 Year before Enactment	$50,001 to $100,000	6 years
2 Years before Enactment	$50,001 to $100,000	5 years
3 Years before Enactment	$50,001 to $100,000	4 years
Year of Enactment or Later	$50,000 or less	5 years
1 Year before Enactment	$50,000 or less	4 years
2 Years before Enactment	$50,000 or less	3 years
3 Years before Enactment	$50,000 or less	2 years

CONCLUDING COMMENTS

The National Association of Enrolled Agents thanks you for the opportunity to comment on H.R. 3035. As we stated earlier, H.R. 3035 has the potential to be a landmark in both simplification and fairness. Chairman Rostenkowski's efforts in furthering the simplification of the Internal Revenue Code are appreciated by our members both as taxpayers as well as tax professionals. We stand ready to assist you with this endeavor and would be pleased to further discuss the issues which we have raised. I would be happy to answer any questions that you may have.

STATEMENT OF THE NATIONAL ASSOCIATION OF INSURANCE BROKERS

INTRODUCTION

This statement is being submitted on behalf of the National Association of Insurance Brokers ("NAIB") a trade association of commercial insurance brokers with respect to the Senate Finance Committee hearing of April 28, 1992, concerning the tax treatment of intangible assets. The NAIB was founded in 1934, its members, which range in size from large international companies to regional and local firms, provide insurance and risk management services to clients in the United States and around the world. NAIB members administer the majority of the coverage in the $110 billion commercial property-casualty insurance market in the United States.

The NAIB applauds the interest of the Senate Finance Committee and the Congress with respect to possible legislation to simplify the tax law with respect to the amortization of intangible assets (including goodwill). In particularly, the NAIB supports enactment of legislation like that contained in Section 4501 of H.R. 4021, the "Tax Fairness and Economic Growth Act of 1992," which was recently passed by the House and Senate. In addition, the NAIB applauds the efforts of Senators Daschle and Symms for leading the way in addressing the problems with respect to the tax treatment of intangibles through the introduction of S. 1245, the "Amortization of Intangibles Clarification Act of 1991," legislation which is currently cosponsored by 19 Senators. In addition, the NAIB strongly believes that any bill addressing the amortization of customer based intangible assets must clarify current law for assets acquired prior to the effective date of any new legislation. Clarification of existing law will not constitute retroactive legislation. To the contrary, clarification will put an end to the new interpretation of the law currently being retroactively administered by the Internal Revenue Service (the "Service"). The principal customer based intangible asset utilized by members of the NAIB is generally referred to as Insurance Expirations. Insurance Expirations have many characteristics which are briefly described in the attached Appendix. In summary, the Insurance Expiration asset is (i) comprised of exclusive information detailing each client's insurance coverage, (ii) used as the primary productive asset in the insurance brokerage business, (iii) generally protected from misuse by procedures and commercial agreements, (iv) regarded by the courts and the insurance industry as an asset capable of ownership, (v) bought and sold in separate transactions and (vi) recognized as a separate asset under generally accepted accounting principles. Insurance Expirations are the most significant asset of an insurance broker and constitute the major portion of the cost associated with the acquisition of an insurance broker.

GENERAL OVERVIEW OF CURRENT LAW AND THE NEED FOR CLARIFICATION

a. General Principles of Tax Law Relevant to the Amortization of Customer Based Intangible Assets

To isolate the issues surrounding the NAIB's position that current law must be clarified, a simplified discussion of the general principles involved is appropriate. Simplicity is appropriate because (i) the tax principles applicable to the amortization of customer based intangibles are simple and (ii) the written testimony separately submitted by the Amortization of Intangibles Task Force provides the technical basis underlying this discussion.

First, it is a generally accepted principle of tax law that expenses associated with producing revenue should be allowed as a deduction to arrive at taxable income. This matching principle is at the very foundation of our tax law and should be viewed as a cornerstone of sound tax policy.

Second, when an asset having a useful life greater than one taxable year is acquired, this matching principle dictates that the cost of the asset must be depreciated or amortized over the useful life of the asset. Depreciation or amortization is required so that deductions associated with the cost of the asset are properly aligned with the revenue generated by the asset. This principle applies to tangible as well as intangible property.

Third, to depreciate or amortize the cost of an asset a taxpayer must be able to reasonably establish the value of the asset and the useful life of the asset.

Fourth, goodwill historically has not been depreciable or amortizable because its useful life is indeterminable or indefinite. But for this fact, there is no reason in tax logic or policy to disallow depreciation or amortization of goodwill.

Fifth, starting at least in 1974 and running until quite recently, taxpayers have been able to amortize customer based intangible assets if they were able to reasonably establish the value and useful lives of the assets. Thus, the rules for customer based intangibles have been the same as for depreciation of tangible assets.

In summary, as with the acquisition of tangible assets used in a taxpayer's trade or business, the Service's published rulings and court decisions have permitted amortization of customer based intangible assets provided a taxpayer demonstrated that the asset has a separate value and a useful life. Those principles, the same principles applied to machinery and equipment, have allowed for the proper matching of the cost of customer based intangibles against the revenue generated by such assets. Since service businesses rely on customer based intangible assets to generate revenue, amortization of the cost of such assets over their useful lives has permitted proper reflection of a service business' taxable income.

As a result of these principles, taxpayers acquiring ongoing businesses with customer based intangibles have anticipated that if they could demonstrate a separate value and useful life for such assets they would be able to write-off the cost of such assets against the revenues generated by those assets. These anticipated tax savings have been included in the pricing models used when such ongoing businesses are acquired. A premium has been paid for such customer based intangible assets. Additionally, many taxpayers have engaged and paid significant fees to expert third-party appraisers to conduct valuation and useful life studies to support the separate value and useful life of acquired customer based intangible assets.

b. The Service's Coordinated Issue Paper Results in a New and Retroactive Interpretation of Tax Law Which Results in Questionable Tax Policy

In 1990 the Service complicated the rather simple principles of tax law relevant to the amortization of customer based intangible assets. The Service's Coordinated Issue Paper ("Issue Paper"), an informal document internally distributed to Revenue Agents, directs Revenue Agents to disallow amortization deductions for customer based intangible assets acquired together with other assets of an ongoing business. The Issue Paper holds that if customer based intangibles are acquired as part of an ongoing business such assets are goodwill as a matter of law. Since goodwill is presumed to have no determinable useful life, the separate value of the customer based intangible cannot be amortized.

It is respectfully submitted that this is a new and retroactive interpretation of the law (indeed a return to the Service's position announced in 1965 that was rejected by the Service in 1974). The Service's new interpretation categorically denies amortization of customer based intangibles and renders meaningless the premium paid by taxpayers when they acquired these assets and the expense and effort incurred by taxpayers to value and determine the useful life of these assets.

The Issue Paper admits that customer based intangible assets may have separate value and a useful life if they are separately acquired. Curiously, however, if such assets are acquired as part of the acquisition of an ongoing business, they are some-

how transformed into the amorphous concept of goodwill. Clearly, the Issue Paper has eliminated, at least upon audit, the separate value and useful life tests that taxpayers have relied upon at least since 1974 to amortize acquired customer based intangible assets.

Without clarifying current law by legislation, taxpayers are left with a retroactive change in the law upon audit and the costly task of proving during litigation that a particular customer based intangible is not goodwill. In addition to the two prong test of separate value and useful life, the government is now apparently arguing that taxpayers must also prove the negative—customer based intangibles do not constitute goodwill.[1] Effectively, the government is now arguing that taxpayers must satisfy a three part test. Taxpayers are being required to demonstrate that customer based intangibles (1) have separate value, (2) have a useful life and (3) are not goodwill.[2]

The new interpretation, whether administered by the Service during audit or during litigation, is bad tax policy. It penalizes service industries and distorts their taxable income by ignoring the simple principles of tax law. While manufacturing industries can continue to depreciate tangible property used in their businesses provided a separate value and useful life for such property can be demonstrated, service businesses that utilize customer based intangible assets to generate revenue are, under the new interpretation, denied amortization deductions even where the taxpayer has supported a separate value and useful life of the customer based intangible asset.

ACTION SUGGESTED

The NAIB respectfully urges this Committee to enact as part of any tax simplification legislation, legislation similar to that contained in Section 4501 of H.R. 4210. The NAIB believes that enactment of such legislation would represent a historic simplification of the existing tax law applicable to the tax treatment of intangibles. Moreover, the NAIB strongly believes that legislation should be included with any intangibles simplification legislation to clarify the treatment of intangibles for assets acquired in prior transactions. The approach taken to this problem through the 17-year rule provided in Section 4501 of H.R. 4210 is one acceptable approach to this problem although the 17-year period should be reduced to 14 years to conform it to the general rule contained in that legislation. Alternatively, the NAIB supports a clarification of the law applicable to previously acquired transactions through applications of the principles contained in S. 1245.

The United States Supreme Court recently granted the taxpayer's request that the Court review the Third Circuit's decision.

APPENDIX—INSURANCE EXPIRATIONS ARE THE PRIMARY PRODUCTIVE ASSET IN THE INSURANCE BROKERAGE BUSINESS AND THEY HAVE A LIMITED USEFUL LIFE

A. PRODUCTIVE NATURE OF INSURANCE EXPIRATION ASSETS

Commercial insurance brokers recommend, place and service insurance and risk management programs on behalf of businesses, organizations, governmental agencies and individuals. Commercial insurance brokers are typically engaged to identify and define risks (e.g., property, general and property liability, environmental, marine and transportation risks) and locate insurance markets to provide insurance coverage.

The information that comprises the customer based intangible asset known as Insurance Expirations is the quintessential asset of an insurance broker's business. The exclusive information that comprises the Insurance Expiration asset allows insurance brokers to reliably and efficiently generate revenue. The Insurance Expiration asset has been defined to consist of the following:

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[1] It is submitted that in this instance the task to prove that a customer based intangible is not goodwill becomes virtually impossible since the concept of goodwill is amorphous.

[2] This third test is illustrated by the recent Third Circuit decision, *Newark Morning Ledger Co. v. U.S. No. 90–5637 (3rd Cir. 1991), reversing,* 734 F. Supp. 176 (D.N.J. 1990). The Justice Department's brief did not frame the issue as a matter of separate value and useful life. Rather, the Justice Department framed the issue for the court as follows:

Whether a purchaser of a newspaper business may treat the subscription revenue anticipated from the continuing patronage of existing subscribers as an asset that is separate from the goodwill of the business and is amortizable under Section 167 of the Internal Revenue Code.

Brief for the Appellant, at 1.

[I]nformation relating to a customer's name, address, and the nature of his insurance coverage with the agency, i.e., name of the carrier(s), type and number of lines, expiration (renewal) dates, premium amounts and schedules, payment ledgers, reports, and a summary of policy terms.[3]

Among other uses, Insurance Expirations are used by brokers to timely renew and adjust a client's insurance coverage.[4] The information that comprises the Insurance Expiration asset allows insurance brokers to timely evaluate (i) whether a client should continue to insure or self-insure its risks, (ii) whether a client can reduce its cost or increase the services its receives (such as claims handling) by obtaining coverage from a different insurance carrier or (iii) whether a change in a client's business (e.g., exposure to new risks) requires enhancements to existing insurance coverage or new coverage altogether. In addition to enabling timely renewal and adjustment of coverage, Insurance Expiration information allows insurance brokers to provide other quality risk management services including (i) comparing a client's coverage with coverage provided to others with similar risks, (ii) recommending other risk management and related services to clients and (iii) developing and marketing "group" insurance programs for clients that share similar risks and require similar insurance protection. Simply stated, the insurance broker that possesses the information that comprises the Insurance Expiration asset has a significant competitive advantage and can generally outperform its competition with respect to that client.

Due to the confidential nature of the Insurance Expiration asset, insurance brokers will generally institute procedures within their firms to help assure that employees, former-employees, co-brokers, insurers and competitors are not able to obtain and misuse the Insurance Expiration asset for their own commercial gain. When such assets are misused by employees, former employees or co-brokers or are unfairly obtained by competitors, the courts have recognized the commercial value of Insurance Expirations and have enforced the terms of agreements protecting the confidential nature of such assets or enforced common law contract and fiduciary standards to protect the rightful owner of the asset.[5] Disputes regarding the ownership or use of Insurance Expirations are often settled without the necessity of litigation. Such settlements have required the return of the Insurance Expiration asset to the broker claiming exclusive ownership, enjoining the wrongful taker from the future use of the asset or compensating the rightful owner equal to the value of the asset.

In addition to the courts, the insurance brokerage industry and insurance carriers recognize an insurance broker's exclusive ownership rights to its Insurance Expirations. In agency agreements between an insurance broker and an insurance carrier, the insurance broker is recognized as the owner of the Insurance Expirations although the insurance carrier can seize the Insurance Expiration pursuant to the agency agreement if the insurance broker is delinquent in remitting premiums. In other words, the agency agreement treats the Insurance Expiration asset as collateral for the insurance broker's obligation to remit premiums to the carrier.

Similar to tangible assets, Insurance Expirations are6bought and sold among insurance brokers in separate transactions.[6] (Goodwill, on the other hand, is incapable of being separately bought and sold.[7]) A market for Insurance Expirations exists because, as indicated above, ownership of Insurance Expirations affords insurance brokers a competitive advantage and because some brokers that specialize in providing particular types of insurance often desire to acquire Insurance Expirations within their specialty. Conversely, brokers that do not desire to specialize will often sell acquired or developed Insurance Expirations that require specialized knowledge.

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[3] *Robins & Weill, Inc.* v. *U.S.*, 74–2 USTC ¶19789, at 85,593 (M.D.N.C. 1974).

[4] *Richard S. Miller & Sons. Inc.* v. *U.S.*, 76–2 ¶USTC 19481, at 84,522 (Ct.Cl. 1976)

[5] *Alexander & Alexander Inc.* v. *Van Impe*, 787 F.2d 163 (3rd Cir. 1986); *Alexander & Alexander Benefits Services Inc.* v. *Benefits Brokers & Consultants. Inc.*, 756 F. Supp. 1408 D. Ore. 1991); *Alexander & Alexander Inc.* v. *Dravton*. 378 F. Supp. 824 (E.D. Pa. 1974); *Alexander & Alexander Inc.* v. *Danahy*, 488 N.E. 2nd 22 (Mass. Ct. App. 1986). *Alexander & Alexander Services Inc.* v. *Frederick Reed. et al.*, No. 84 CH 9844 (Cook County, Ill. Cir. Ct. 1986). The Uniform Trade Secrets Act has been enacted in over a dozen states. It generally codifies existing common law principles protecting an employers confidential information about its clients and customers. The case *Alexander & Alexander Benefits Services. Inc.* v. *Benefits brokers & Consultants. Inc.*, supra, holds that an insurance broker's confidential information about its clients' renewal dates, losses and risk characteristics were trade secrets under the Oregon Uniform Trade Secrets Act, and thus entitled to the protection afforded by that act.

[6] The U.S. Court of Claims in *Richard S. Miller & Sons*, 76–2 USTC at 84,525, acknowledged the insurance expirations can be sold in discrete transactions.

[7] *Dodge Brothers Inc.* v. *U.S.*, 118 F.2d 95 (4th Cir. 1941) citing *Metropolitan National Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436 (S.C. 1893).

Since Insurance Expirations have recognized commercial value, they have been used as collateral in commercial transactions. Additionally, security interests have been perfected under the Uniform Commercial Code when Insurance Expirations have been sold and full payment has not been received at the time of sale.

The accounting profession recognizes that Insurance Expirations are a separate asset that constitutes the major portion of the cost associated with the acquisition of an insurance broker.[8] The accounting profession has acknowledged that Insurance Expirations are an "identifiable" asset that is distinguishable from goodwill. Generally accepted accounting principles ("GAAP") and the tax law are similar in that intangible assets must be identified, valued and amortized over their estimated useful lives. GAAP requires an allocation of fair market value to intangible assets to insure that expenses are not understated and are properly matched with revenue.[9]

Other governmental agencies have also recognized the existence of the Insurance Expiration asset and issued guidelines regarding the method to value such assets. For example, the Federal Home Loan Bank Board has issued specific valuation guidelines regarding the method to properly value Insurance Expirations so as to provide standards to produce satisfactory evidence to support the purchase price of insurance agencies and brokers.[10]

B. INSURANCE EXPIRATIONS HAVE A LIMITED USEFUL LIFE

Common sense indicates that the information that comprises the Insurance Expiration asset has a limited useful life since that information will become obsolete over a period of time. Factors that influence the obsolescence of Insurance Expirations include: (i) price competition on premiums and fees charged for coverage; (ii) changes in the client's risk management personnel and philosophy; (iii) competitors' efforts to convince a client that it can better serve that client's insurance brokerage and risk management needs and (iv) changes in the risk management needs of a client due to, among other reasons, mergers, liquidations, expansion, contraction or discontinuance of lines of business, changes in governmental regulations and standards, litigation hazards and changes in insurance carriers' willingness and ability to provide insurance coverage.

Insurance industry statistics indicate that an average Insurance Expiration has a useful life of seven years.[11] However, actual useful lives will vary depending on type of coverage, amount of commission, insurance broker practices and procedures to protect the asset, competitors' efforts and local economic factors.

STATEMENT OF THE NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS

Mr. Chairman and members of the Committee, I am Henry Batjer of San Angelo, Texas. I am a partner of Trimble-Batjer Insurance Associates, an independent insurance agency that has been in business since 1883. My statement is on behalf of the National Association of Professional Insurance Agents. PIA represents 185,000 independent agents and their employees across the country writing all lines of insurance. I serve as a board member of PIA of Texas. I greatly appreciate this opportunity to present my experiences before the Finance Committee. Thank you, Mr. Chairman, for your active interest in this issue of profound importance to the community of insurance agents and brokers.

I'm 71 years old, and while active in my agency, I've been methodically selling my ownership interest over a number of years in anticipation of retirement. Due to uncertainties in the interpretation of laws affecting intangible assets, my partners recently took a giant tax hit. As a result of our experience, I'm convinced that enormous confusion exists in the marketplace over appropriate allocation of intangible asset deductions. This confusion is leading to increasingly inequitable and unjustifiable treatment of taxpayers. Though it is probably too late to help us, I strongly support legislation designed to clarify the Tax Code on this issue with a goal of applying fair, predictable, across-the-board standards.

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[8] Insurance Agents and Brokers Task Force of the Insurance Companies Committee, Accounting Standards Division, American Institute of Certified Public Accountants, *Exposure Draft Proposed Industry Accounting Guide. Insurance Agents and Brokers*, par. 8.4, August 15, 1991.

[9] Accounting Principles Board Opinion 16, "Business Combinations" and Accounting Principles Board Opinion 17, "Intangible Assets."

[10] FHLBB #R-28 Memorandum Series, #R-28b (April 1976). The purpose of the FHLBB guidelines is to provide support for a loan since lenders attempt to avoid making loans that exceed the value of the assets acquired by borrowers.

[11] *Vaaler Insurance Inc.* v. *U.S.*, 68-1 USTC ¶9183, at 86,284 (D.N.D.)

Allow me to give you some background. I started my own agency on August 1, 1949, earning $1,200 in my first year. In 1950 I was recalled for service in Korea for two years. In 1954, I merged my agency into the Russell Trimble Agency, with three of us serving as partners of "Trimble-Batjer Insurance Associates." We've successfully grown over the years, and currently we have 43 employees. Like most of today's independent insurance agencies, about 70 percent of our property/casualty business is in commercial insurance, 30 percent in personal lines. We have a property/casualty commission income of about $2 million annually, representing between $15–16 million in premium volume. Additionally, we sell group life and health products resulting in about $600,000 in commission income.

San Angelo is a community of about 90,000 people with a diversified economy. There aren't many agencies that are takeover targets, and we haven't grown over the years through mergers or acquisitions. Our method of growth has been to hire bright people and let them earn an opportunity to buy into ownership of the agency. Typically, after a period of a couple of years, we offer aspiring partners the ability to pay a fair market value for a percentage of the business.

The idea, of course, is to keep the business going with the same proprietary spirit that existed when the firm was founded 108 years ago. In 1970, I owned 55 percent of the agency. Today, I own less than 5 percent.

Ever since we set our "perpetuation" plan in motion by selling shares of ownership 21 years ago, we have used a uniform standard for valuation based on the weighted average of three years of commission income. If the business is growing, more value is assigned through the formula. We never have taken goodwill into account in these transactions because the "buyers" of the agency have already created the goodwill. In the rare instances when we have purchased small agencies in financial distress, we have assigned a value to goodwill in the purchase price, somewhere between 10 and 15 percent.

In our transfers of ownership internally, the value of our insurance expirations has been depreciated by the purchasing partners under the Section 754 Option. This amortization is based on the documented loss rate in our policy renewals. From 1985 to 1990, on an annual basis, we've experienced non-renewals in the range of 7.9 percent to 12.5 percent on a total of 4,500 files.

We were audited by the IRS last year for the tax years 1987–89. We were informed that one area of concern was some bad-debt chargeoffs. Ultimately, the IRS agreed completely with our position on that issue. We were also told by the IRS that all depreciation deductions by the purchasing partners for expirations in those years would be disallowed. The ownership interest sold during the period from 1981–88 represented almost 50 percent of the value of the agency, with a sales price near $550,000. The IRS appeals officer told us that it is difficult to prove the two-pronged test of life of the policy expirations and their value. He insisted on assigning a goodwill value to the total. He said this was a controversial, national issue and that interpretations of the law were under debate.

We were armed, of course, with documentation that clearly demonstrated the limited lifespan and reasonable value of our customer lists. I believe that this clearly meets the two-part test for intangible asset amortization under current law. Yet the IRS's position—as expressed in the "Coordinated Issue Paper"—would reject current law and disallow depreciation deductions for intangible assets wherever the IRS deems goodwill to be present in a transaction. We were never informed of this issue paper during our audit, but it's clear to me and my associates that it has fueled the uncertainty. I'm almost sympathetic to the field agents—as sympathetic as one can be to the IRS—who are stuck between current law on the one hand, and the "Coordinated Issue Paper" on the other.

As our case progressed, we grudgingly offered to allocate to goodwill 30 percent of the purchase price of ownership transfers at issue—even though we still believe strongly that goodwill (in the legal sense) was not present.

We waved the white flag in mid-July of 1991. In the end, the IRS got 60 percent of the face amount of those notes assigned to goodwill. This amounted to an extra, unexpected tax burden of about $60,000 to the purchasing partners, plus their legal and accounting fees. We felt robbed—not by the IRS agents specifically, but by a system that is enormously confusing and inconsistent.

I suppose that we could have appealed this all the way. My college degree was in finance and accounting, so I had strong views about the propriety of our actions. But for a small businessman fighting the IRS, it's uneconomical. We were paying for a team of attorneys and accountants. Plus there was a significant overhead cost incurred from the distractions of digging up all the important data and verifications. The partners who purchased ownership interest in our agency lost between 15 and 30 percent of the value of their investment, depending on their tax brackets. Obviously, had I known this outcome in advance, I would have adjusted the purchase

price significantly. In trying to fairly address the situation now, we face the unhappy prospect of these partners having to pay taxes on any debt forgiveness if the sales price is reduced retroactively!

Mr. Chairman, a 14-year amortization schedule for intangible assets strikes me as too long from our documented experience. But the elimination of the hassle and confusion makes your proposal much better than the current system. It seems to me and my associates to be a reasonable compromise—particularly if you're willing to do something to clarify the law with regard to transactions currently in the pipeline. (I recognize that my case is closed in any event.) Today, we've learned the hard way that you can't count on the present system. It has been a crapshoot, no matter how well you've documented your facts and tried to comply with the law.

PIA appreciates your efforts, along with that of Senators Daschle and Symms, and Representatives Vander Jagt, Anthony and Kennelly to solve this problem and simplify the system. For the sake of sound tax policy and fairness to taxpayers, we strongly urge you to move forward with proposals to solve this dilemma. Again, thank you for your leadership.

STATEMENT OF THE NATIONAL CABLE TELEVISION ASSOCIATION

The National Cable Television Association, which represents cable companies serving more than 90 percent of all cable subscribers in the United States and more than 60 cable programming networks engaged in creating and distributing a broad range of programming, appreciates this opportunity to offer the cable industry's views regarding the simplification of the tax treatment of intangible assets acquired in business purchases.

The cable television industry strongly supports the goal of simplifying the tax treatment of intangible assets in order to eliminate the controversy and costly disputes which now occur between taxpayers and the Internal Revenue Service. More specifically, the cable industry fully endorses Subtitle E (Treatment of Intangibles) of the Senate and House of Representatives conference agreement on H.R.4210, the Tax Fairness and Economic Growth Act of 1992, which sets a 14-year amortization period for intangible assets, and clearly includes government licenses, including cable television franchises, within the definition of such assets.

The tax issues related to the purchase of intangible assets have heretofore been a source of great confusion because both taxpayers and the Internal Revenue Service have been forced to rely on a large body of often ill-defined case law for tax guidance. The result has been uncertainty about the tax treatment of intangible assets which has lead to time-consuming, costly appraisals and burdensome disputes between taxpayers and the I.R.S. The cable industry believes that the best course for alleviating these burdens is to simplify, through statute, the tax treatment of intangible assets.

The cable television industry believes that the recent agreement of the Senate and House conferees on an intangibles provision in H.R. 4210 resulted in workable language for achieving the goals of simplifying the tax treatment of intangible assets. Specifically, we support the conference's decision not to exclude governmental licenses and permits, including cable television franchises, from the definition of intangible assets eligible for 14-year amortization. The exclusion of such assets has no logical basis since other intangibles with indefinite lives, most notably goodwill, could be amortized.

We believe that the inclusion of governmental licenses will serve to minimize confusion, costly appraisals and tax disputes for two reasons. First, existing disputes resulting from reliance on the current, ill-defined case law will be eliminated. Second, the inclusion of government licenses in the definition of intangible assets will eliminate the uncertain task of differentiating the value of government licenses from the value of goodwill. This benefit of the conference bill is important because where goodwill is subject to amortization, as it was under the conference agreement, the value of goodwill would be virtually impossible to distinguish from the value of the governmental license. To permit the amortization of such intangibles as goodwill and to deny amortization of government licenses would not only perpetuate the conflicts inherent in the current system, but also create new grounds for further dispute.

STATEMENT OF THE NATIONAL GOVERNORS ASSOCIATION

Thank you Mr. Chairman and members of the Subcommittee for the opportunity to discuss the states' experience with enterprise zones and opportunities for federal-state cooperation.

The nation's Governors welcome federal involvement in this area, but we strongly urge you to ensure that federal activities build upon, not conflict with, existing state and local efforts. With all levels of government working together, we can produce even more effective enterprise zone efforts, but competition will only undermine these opportunities.

Less than ten years after Connecticut started the first enterprise zone in 1982, thirty-seven states and the District of Columbia have instituted some version of the enterprise zone concept. These zones rely on a wide range of incentives to reinvigorate economically depressed areas, to create jobs, and to stimulate private investment. States have tried a wide range of incentives, including property, sales, and payroll tax breaks; low-interest loans and venture capital funds; regulatory relief; and infrastructure support, to name just a few.

Regardless of the particular combination of incentives employed within a zone — and each zone has different needs -- the majority of states have found the enterprise zone program a very effective weapon in the economic development armory. According to one analysis, state development zones by 1988 had created 184,000 new jobs, preserved another 170,000, and produced $18 billion in new investment. For example, Alabama's enterprise zone has generated $88 billion in capital investment and 2,400 jobs since 1987.

Furthermore, enterprise zones pay for themselves; they ultimately produce more tax revenue than they forfeit in breaks and abatements. For example, in testimony presented to this committee in 1989, one economist stated that New Jersey's enterprise zone program generated approximately $1.90 for every $1.00 in tax incentives. Michigan estimates that its zone has garnered $40 million in private funds while costing only $1 million per year.

Let me give you some specifics on how effectively enterprise zones can turn around local communities.

When Paducah, Kentucky, was designated an enterprise zone in 1986, the area's unemployment rate was one and one-half times the national average and the vacancy rate in the central business district was close to 75 percent. State officials devised a range of investment incentives, including state tax exemptions on construction materials, equipment purchases, and loan interest payments. There also was a city tax reduction on real property and opportunities to receive free business licenses for the first five years of operation.

In addition, a number of support programs were initiated to complement the tax incentives. With well-maintained infrastructure, the enterprise zone concentrated on improving the business environment, including building a riverfront park to link the central business district with hotels and a convention center.

All of the activities produced impressive results. According to a 1988 analysis conducted by the National Association of State Development Agencies, the Paducah enterprise zone stopped the exodus of businesses from the central district, decreased vacancy rates by 33 percent, and encouraged existing firms to expand their operations. One employer cited the enterprise zone tax abatements as the critical factor in influencing its decision to stay in Paducah and invest $42 million in upgrading equipment.

In an urban setting, Newark's enterprise zone also has proven quite successful. Since 1984, the state has offered a sales tax exemption on equipment, services and materials used on construction within the zone.

Businesses located in the zone also get a 50 percent cut in retail sales tax; the other half is deposited into a trust fund for direct zone investment. Newark has used this fund to hire more police officers, among other activities. Finally, the city of Newark itself offers low-interest loans and venture capital for start-ups and expansions.

Like Paducah, Newark's enterprise zone enhanced economic development in a severely depressed economy. Six years after starting the program, the Newark zone had attracted 403 new businesses, generated investments worth $528 million and produced 2,748 new full-time and 678 part-time jobs.

Lessons from State Experiences

Now that enterprise zones are nearly a decade old, states and localities are devising more sophisticated programs, with more refined and comprehensive incentive packages. These zones no longer are aimed just at attracting new business, but also at encouraging existing firms to expand.

Our experience at the state level has demonstrated that the most successful enterprise zone programs carefully match incentives with goals; generally, the closer the match, the better the results.

Effective enterprise zones also tend to be comprehensive and multifaceted. Since economically disadvantaged areas face a variety of well-entrenched stresses and difficulties, many factors contribute to a winning enterprise zone formula. Depending on the particular local circumstances, resources must be focused on such diverse needs as child care, construction, public safety, street repair, or job training, in addition to investment tax incentives.

Although we can point to many examples where enterprise zones have successfully renovated a local economy, there's no doubt that the program could become even more effective with the addition of federal incentives. Still, it's critical that these federal efforts complement -- not replace or undermine -- state and local initiatives. As the National Governors' Association policy states:

> Federal enterprise zone legislation should set broad geographic targeting guidelines within which states can certify locally developed zone boundaries. A package of complementary federal, state, and local incentives; investments; and services should be negotiated in a cooperative agreement among all affected levels of government.

We cannot afford to have too many conflicting federal and state zone designations, for example. States carefully select the number and distribution of enterprise zones. If we designate too many, we risk producing a broad but weak program; too few, and we could miss important opportunities for private investment.

These decisions are tough to make. We must select areas that already possess enough resources to make added investment worthwhile without sacrificing communities needlessly. There are many areas in need and as Governors we are forced to set priorities. If federal enterprise zones ignore these decisions, state and local activities will be seriously weakened.

Federal support also should enhance the program activities already in place and recognize state and local needs for flexibility. No single approach can work in all enterprise zone areas. In fact, successful programs often reflect close cooperation between state and local officials in tailoring activities to specific community needs.

In Paducah, Kentucky, for instance, state and local officials and private investors concluded that a number of factors influenced investment. Although tax breaks were the most powerful tool, new construction, business development, and even marketing efforts were critical.

Similarly, the Newark experience demonstrated that the stronger the surrounding community, the better the chance of stimulating private investment. When residents feel secure in their environment and the business climate improves, investors are more inclined to add resources to the community base. Even the best enterprise zone will fail if major sources of economic distress remain untreated.

Whether New Jersey, Kentucky, or any of the 35 other enterprise zone states, success often has involved state and local officials working closely together to design the best program for each particular zone. State and local authorities are best positioned to manage enterprise zones. While federal support can help leverage existing activities, we must have the flexibility to serve local needs.

The National Governors' Association encourages you to move forward with enterprise zone legislation. The addition of federal incentives can make a successful program even better. Yet we urge you to ensure that federal activities complement, not conflict with, ongoing state programs. With states, localities, and the federal government all working together we can enhance economic development.

Thank you.

STATE ENTERPRISE ZONE PROGRAMS

Incentive	Number of States
Property Tax Reduction/Abatement	16
Credit for Interest Paid on Loans	8
Investment Credits	11
Sales Tax Relief	21
Employer Income Tax Credit	24
Employee Income Tax Credit	4
Job Creation/Wage Credit	22
Credit for Selective Hiring	19
Direct State Loans	14
Other Capital Financing Support	14
Infrastructure/Public Service Improvements	12
Program Targeting	17
Regulatory Relief	19

Source: State Enterprise Zone Roundup, National Association of State Development Agencies, October 1988.

E-10. ENTERPRISE ZONES

Thirty-seven states have initiated programs based on the "enterprise zone" concept, a mechanism for encouraging private sector job creation and revitalization in blighted areas of distressed cities and in rural areas, and in addition for strengthening job retention efforts in rural areas whose economies are depressed. A wide range of tax and regulatory provisions have been adopted in these states as incentives for development within the zones. As laboratories of the federal system, states are leading the way in testing, evaluating, and redesigning the concept of enterprise zones.

Because of the widespread interest in the program, it is important that steps be taken to implement on a pilot basis a federal enterprise zone program, both to strengthen and improve the incentives already available in state programs and to determine the effectiveness of this concept.

The primary objectives of enterprise zones should be to increase the rate of business formation; encourage expansion of newer, small firms; improve current efforts at job retention; and expand opportunities for disadvantaged workers in designated distressed areas. Federal enterprise zone legislation should set broad geographic targeting guidelines within which states can certify locally developed zone boundaries. A package of complementary federal, state, and local incentives; investments; and services should be developed for each designated zone and should be negotiated in a cooperative agreement among all affected levels of government.

The success of a federal program will depend upon the ability to leverage the existing and future state and local efforts directed at these same goals.

Adopted August 1989.

NGA POLICY POSITIONS, 1991-92

STATEMENT OF THE NATIONAL SOFT DRINK ASSOCIATION

Mr. Chairman and Members of the Committee, the National Soft Drink Association welcomes the opportunity to submit this statement in support of Congressional activity to establish a uniform rate for depreciation of intangible assets.

We would like to express our appreciation to the Chairman for his willingness to hear the issue in Committee in the broader contact of tax simplification.

The National Soft Drink Association represents more than 700 sort drink bottlers and parent franchise companies who support Congressional efforts to enact legislation which will end the uncertainty which currently exists with respect to the tax treatment of intangible assets.

The sort drink industry endorses a single, uniform amortization schedule as one that ends years of uncertainty concerning the depreciation of intangible assets, including franchises. NSDA recognizes the importance of revenue neutrality in this instance, and therefore would concur with legislation based on that principle with respect to this issue.

Legislation pending in the other body sets the amortization schedule at 14 years based on revenue neutrality. NSDA supports the goal of revenue neutrality and urges Congress to follow that principle when considering this issue.

The establishment of a single useful life for this class of assets is a move in the right direction for sound business practices in general and the sort drink industry in particular. We applaud the Chairman for his leadership in opening the issue up for public comment.

STATEMENT OF PATTON, BOGGS & BLOW

INTRODUCTION

Provisions included in H.R. 4210 earlier this year would have added a new section 197 to the Internal Revenue Code to allow the costs of certain specified intangible assets (including goodwill and going concern value) acquired after the date of enactment to be amortized by the acquiring party over a 14-year period. Proposed section 197 also contained a so-called "anti-churning" rule to prevent taxpayers from creating amortization deductions by (for example) transferring certain previously-owned,

and thus nonamortizable, intangible assets to a related person which would then claim the amortization deductions as a post-enactment purchaser. Specifically, under the anti-churning rule, a "related" purchaser of intangible assets that were created by the seller (i.e., self-created intangibles) will be denied otherwise allowable amortization deductions if the intangibles were used by the seller between July 25, 1991 and the date of enactment. Parties are "related" if, for example, the seller has at least a 20 percent interest in the purchaser.

The anti-churning rule (proposed section 197(f)(9)) should be modified to exclude self-created intangibles. Absent such a change, similarly situated taxpayers will be treated differently and the application of proposed section 197(f)(9) will generate greater complexity and tax compliance controversies than under currently existing law. Such a rule will not promote tax avoidance because taxpayers have a zero basis in self-created intangibles. A similar exclusion should apply to the transfer of purchased intangibles to the extent the related transferee has a basis which exceeds that of the transferor. See proposed section 197(f)(2).

TAX EQUITY

The legislative history of H.R. 4210 states that the antichurning rules are intended to prevent taxpayers from converting existing intangibles, not amortizable under current law, into amortizable property to which proposed section 197 would apply. Otherwise stated, the anti-churning rules are intended to prevent purely tax driven transactions that benefit taxpayers at the expense of the U.S. Treasury.

With existing purchased intangibles (i.e., intangibles in which the seller has tax basis for determining gain or loss), the opportunity for abusive churning of the type at which the anti-churning rules are aimed clearly exists. If such "purchased intangibles" are sold, the related seller would not recognize a taxable gain on the sale (to the extent of tax basis in the assets sold) and the related purchaser would claim future amortization deductions based on the entire purchase price. The proposed anti-churning rules cure this potential for abuse with respect to previously purchased intangibles existing on the date of enactment. However, with respect to self-created intangibles, the proposed legislation goes further and prohibits amortization by a purchaser where no incremental tax benefit is available to related taxpayers. This is inappropriate as a matter of tax equity and (as explained below) is at odds with the underlying simplification objectives of the proposed legislation.

Amortization deductions are precluded under both existing law and the proposed legislation for self-created intangibles. When such self-created intangibles are sold, the taxpayer recognizes a current taxable gain. Because the related purchaser cannot obtain an amortizable asset without the related seller recognizing taxable income, aggregate tax benefits that are unavailable under current law would not be available under the proposed legislation, as amended in the manner suggested here. In fact, in most circumstances, it would benefit the U.S. Treasury to have taxable sales (revenue inflow) of self-created intangibles followed by equal amortization deductions (revenue outflow) over time.[1]

More importantly, the proposed treatment of self-created intangibles under the anti-churning rules will create inequity. This is because the value of a related seller's self-created intangibles is diminished in relation to similarly situated taxpayers. While all sellers must recognize taxable income on the sale of their self-created intangibles, the purchaser of self-created intangibles in a transaction subject to the anti-churning rules cannot amortize the intangibles. In such a case, the purchaser will pay less for the intangibles. Three examples illustrate the inequity of extending the anti-churning rules to self-created intangibles.

Example (1). Assume that Company A operates business X (and has done so for the five years preceding the date of enactment of the proposed legislation). Also, assume that, one day following the date of enactment, Company B enters business X and commits resources equal to those committed by Company A, with the result that its business grows to the same size as Company A's within five years. In both cases, no amortizable section 197 assets would exist (i.e., neither Company A nor Company B could amortize their self-created intangibles) and both Company A and Company B would have been historically taxed identically.

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[1] If the seller had sufficient net operating losses ("NOLs") to offset the gain on the sale, aggregate cash flow differentials could benefit taxpayers at the expense of the U.S. Treasury. This conclusion would be valid, however, only if it is assumed that the related seller would not otherwise use the NOL carryforward. The potential ability to absorb NOL carryforwards in limited instances should not be decisive here. Taxpayers with sufficient NOL carryforwards are generally permitted to sell any asset (tangible or intangible) without incurring a current tax while the purchaser generally is entitled to subsequent expense deductions. Self-created intangibles should not be given detrimental treatment in the proposed legislation.

Both Company A and Company B would be taxed upon their sales of their self-created intangibles. However, the purchaser from Company B would be entitled to amortization deductions without restriction (because it did not commence business X until after the date of enactment) while the purchaser from Company A would be restricted. This restriction will result in a lower purchase price for the Company A intangibles. Hence, Company A will be treated inequitably.

Example (2). Anti-churning rules currently exist for sales of tangible property (ACRS–MACRS) and these rules generally place restrictions on a related purchaser's recovery period. For example, if Company A purchases and fully depreciates (i.e., no remaining tax basis) equipment, it will recognize gain on the sale to the extent of the proceeds received. Where the tangible asset anti-churning rules apply, the purchaser will be subject to recovery period restrictions, but the recovery "amount" will not be limited. On the other hand, if Company A possessed self-created intangibles with no tax basis, Company A would recognize taxable gain, but the purchaser's recovery "amount" would be limited under the proposed section 197 anti-churning rules. In both instances, all seller costs associated with the assets would have been deducted and taxable income would be recognized in an amount equal to the proceeds received. Yet, because of the application of section 197, the purchase price of the intangible assets would be lower.

Example (3). Assume that three unrelated parties form a corporate joint venture (via a transaction described in section 351 of the Code), with interests in the joint venture capitalized as follows:

	Ownership	Contribution	
		Cash	Self-Created Intang.
Party A	60%	$1,200	$0
Party B	21	(630)	1,050
Party C	19	(570)	950
Total	100%	$0	$2,000

Parties B and C receive cash plus interest in the venture in exchange for contributing intangibles.

In the transaction, Parties B and C would both recognize taxable income equal to the amount of cash they received (i.e., $630 and $570 respectively). However, the venture could not amortize any of the intangibles contributed by Party B, while it would be permitted to amortize $570 of the intangible contributed by Party C (because proposed section 197(f)(2) limits joint venture amortization to the amount of gain recognized by the contributing party). As a result, Party B will receive a lower price for its intangibles.

SIMPLIFICATION

As noted, proposed section 197(f)(9) generally prohibits related party amortization for intangibles that existed on the date of enactment. Where such assets are sold after the date of enactment in cases to which the anti-churning rules apply, there will be great difficulty in determining if the intangible that was sold in fact existed on the date of enactment.

Example. Assume that Company A operates business X and that it has done so for the five years preceding the date of -enactment. Assume further that Company A commits sufficient resources so that the size of business X quadruples during the five years following enactment. Finally, assume that, immediately after the date of enactment, Company B enters business X and commits resources equal to those committed by Company A so that its business X grows to the same size as that Company A by the end of the five year post-enactment period. Upon the sale of the self-created intangibles by Company A and Company B (the event necessary to create an amortizable intangible) to related parties, all of the self-created intangibles of Company B could be amortized. However, the result is not so clear for Company A even if it made its sale on the same day and at the same price.

Since Company A operated business X prior to the date of enactment, controversy will inevitably arise as to which intangible assets existed on that date. Taxpayers would have to demonstrate which intangibles existing on the purchase date were separate from goodwill and going concern value (as under current law), but they would also be forced to support the value of individual goodwill and going concern intangibles that existed as of the effective date of the legislation plus the remaining value of those specific intangibles that remain on the sale date. This will be expensive and costly and the mere document retention requirements would impose a sig-

nificant burden. Further, disputes may arise as to which intangibles were sold: self-created intangibles existing on the enactment date or intangibles created after that date. Finally, disputes could also arise with respect to whether certain assets existing on the date of enactment that are subsequently sold (i.e., whether previously purchased intangibles or self-created intangibles are being sold).

In summary, the anti-churning rules require a greater burden of proof than is required under current law, impose unrealistic recordkeeping requirements and also significantly increase the potential for controversies between the Internal Revenue Service and taxpayers.

CONCLUSION

For the reasons set forth above, the anti-churning rules of proposed section 197 should not apply to self-created intangibles. An exclusion for self-created intangibles would not encourage the type of tax motivated transactions at which the anti-churning rules are aimed, but it would promote both tax equity and the broader simplification objectives of the legislation. A similar exclusion should apply to the transfer of purchased intangibles to the extent the related transferee has a basis which exceeds that of the transferor. See proposed section 197(f)(2).

Statement of the Petroleum Marketers Association of America

BACKGROUND

Mr. Chairman and members of the Committee, thank you for providing an opportunity to present testimony on the issue of the appropriateness of amortizing intangible assets and goodwill. The Petroleum Marketers Association of America (PMAA) is a federation of 44 state and regional trade associations representing more than 11,000 independent petroleum marketers throughout the United States. These marketers sell about half the gasoline, 75 percent of the home heating oil and 60 percent of the diesel fuel consumed in this country. Eighty-nine percent of PMAA's membership is classified as small business under size categories established by the Small Business Administration.

PMAA appreciates the Chairman's efforts to develop appropriate solutions, and we commend the committee for holding this hearing in an effort to obtain the views of affected industries. We look forward to continuing to work with you and the committee on this important matter. PMAA believes that legislation should be enacted that clarifies what intangibles should be amortizable, and also what the appropriate schedule of amortization should be. However, we have concerns with the legislation now advancing in Congress and which was included in the tax bill that was vetoed by the President.

CUSTOMER LISTS ARE ESSENTIAL TO OUR INDUSTRY

Briefly, PMAA members have a variety of different methods of delivering petroleum products to their customers, and I will describe the two areas that I believe will be most significantly affected by this legislation. First, PMAA members deliver heating oil directly to homeowners and commercial customers. Second, many members deliver motor fuels to farmers, trucking companies, and construction crews who need fuel delivered to them or to a particular site.

For marketers who are active in these two areas, the value of the business relates directly to the customers served. A strong customer list and an extensive penetration of a particular geographic area makes for a valuable business. Without such a list, the business is merely a bulk plant, a small office building, and a few trucks, whose value is reduced with every new environmental regulation. The customers are the business.

Unfortunately, customers do not last forever. Homeowners move. Farmers sell out. Trucking and construction companies go bust. Additionally, some customers find the service or price of a competitor to be better and begin purchasing product from that company. Additionally, the Clean Air Act Amendments will require many customers to transfer their fleets to alternative fuels. As a result, they will not only be lost to a particular marketer, but they will be lost to the entire petroleum marketing industry.

A customer list is the most important asset for many petroleum marketers, but unfortunately, it does not normally last 14 years. Most heating oil dealers currently amortize their customer list over a seven to ten year period. This time has been recognized by the courts, and is in line with surveys indicating that, on average, homeowners move every six years.

COVENANTS NOT TO COMPETE ARE ALSO ESSENTIAL

A second area of concern to petroleum marketers are covenants not to compete. Because many of the companies operated by PMAA members were developed through the hard work of a single individual who penetrated a market and developed a loyal customer base, businesses who acquire that company often enter into a contract preventing that individual from becoming a competitor. Under common law, those covenants must have reasonable terms, which generally means five years.

In the heating oil industry, the value of this covenant not to compete will generally range between 20 percent and 40 percent of the value of the transaction. A depreciation schedule of fourteen years would put a large gap between the value of the covenant and its depreciation schedule and could substantially harm the acquiring company.

PMAA ANALYSIS OF THE PENDING LEGISLATION

While we have focused on actual depreciation schedules and industry practices, PMAA would now like to begin discussing the bills pending before the Congress. Before beginning, PMAA would like to make two points. First, we are representing buyers and sellers, and every buyer is a potential seller. Thus, any tax bill that affects the value of an asset to a buyer, affects the value of all businesses. Further, for many of the small businesses represented by PMAA, the owner's retirement will be financed with the sale of the business they have dedicated their lives to making. Thus, PMAA believes that any legislation developed must not harm those retirement plans.

Second, as small businesses, we do believe that it is appropriate for Congress to enact legislation in this area. We believe that a more uniform, predictable set of rules for amortizing such assets is necessary, particularly in light of recent decisions by the Circuit Courts, one of which is now before the Supreme Court. The uncertainty regarding amortization of intangibles leads to higher than necessary legal and accounting fees, which an act of Congress can reduce. Additionally, the uncertainty of the U.S. Supreme Court review of the Third Circuit decision in *Newark Morning Ledger* Case and the dramatic impact a decision will have on business values will substantially impair the ability of marketers to sell their businesses. Banks will be hesitant to loan funds if the dealer holds out for full value, which means the Supreme Court grant of *certiorari* in the *Newark Morning Ledger* case may already be affecting the value of these businesses. A decision, whether favorable or unfavorable, will not be issued until 1993. Therefore, we believe it is critical that the Congress act to amend the tax code to establish certainty at the earliest possible time.

PMAA RECOMMENDATIONS

Our analysis of the bills presently before the Congress, as well as the General Accounting Office report on this subject, leads us to suggest that H.R. 3035 be modified slightly to reduce its negative impacts on the petroleum marketing industry.

We would respectfully *urge the Congress to allow covenants not to compete to be depreciated over the term of the covenant.* We believe that such an approach would be workable. Amortizing over the term of the contract will be readily susceptible to auditing and evaluation by the Internal Revenue Service (IRS). Additionally, without such a modification, we believe that covenants not to compete will be replaced with consultancy arrangements or employment contracts, which would allow the corporation to expense the costs. Such a change would require IRS policing to prevent gamesmanship, and thus one goal of H.R. 3035, eliminating administrative costs at the IRS, would be lost.

CONCLUSION

We look forward to working with this committee to enact legislation in this area that is simple, good for the economy and fair to the businesses that will be affected.

On behalf of PMAA, I would like to thank the Chairman and members of the committee for receiving our testimony.

STATEMENT OF THE RALSTON PURINA CO.

Ralston Purina Company recommends that greater simplification and fairness be obtained in the Rostenkowski bill, H.R. 3035, by adoption of mass asset accounting. If this change is included, Ralston Purina Company supports H.R. 3035.

Mass asset accounting should replace the unfair disposition gain/loss provisions presently in the bill, to work as follows:

- **For each separate acquisition of a trade or business, the taxpayer would use a single depreciation account for all intangibles acquired. Upon subsequent disposition of any intangibles in the account, the proceeds of each sale would be credited to the depreciation reserve account thereby reducing the remaining depreciation available.**
- **Gain would not be recognized until the sum of accumulated depreciation and sales proceeds credited to the depreciation reserve account exceeds the cost of the acquired intangibles.**
- **Loss would not be recognized until the last intangible asset in the separate account is disposed of or becomes worthless.**

H.R. 3035 STILL REQUIRES APPRAISALS OF ASSETS

An expected benefit of H.R. 3035 is elimination of appraisals of acquired intangibles in an acquired business. This benefit will not be obtained under the bill as written:

- The bill provides for separate determination of gain or loss upon later disposition of acquired intangibles. To compute such gain or loss, tax basis must be determined. This requires allocating the purchase price to individual intangible assets. Such allocation normally demands an appraisal, which contradicts the concept of simplification.
- The appraisal problem becomes more difficult under H.R. 3035 as written than under present law. Under present law, the very first year that amortization is claimed on intangibles, there is an audit issue to be resolved with the IRS. Under H.R. 3035, the issue would not arise until an individual intangible asset is sold, abandoned or becomes worthless in some future year. In this situation, the audit issue is pushed further into the future when the original acquisition appraisal facts may be more difficult to document due to employee departures, sale of company, etc. A prudent taxpayer will have to incur the cost of asset appraisals at the acquisition just as is now done to be able to compute and defer future gain/loss computations.

UNFAIRNESS SHOULD BE CORRECTED

It is grossly unfair to require taxpayers to pay tax on gains and defer deductions for losses on legitimate closed and completed transactions with third parties. If this approach becomes accepted tax policy, one can only imagine the extremes to which it can be carried in the quest for "revenue enhancements" to raise revenue for the government.

RALSTON'S PROPOSAL

Mass asset accounting should be adopted to eliminate:

- The need for appraisal of Section 197 intangibles.
- The inequitable treatment under the bill of requiring deferral of losses until the end of the fourteen year period and immediate taxation of gains on dispositions of intangible assets.

We propose creating a *separate intangible depreciation account (vintage account)* for each acquisition. All Section 197 intangibles would be included in that single account. The tangible assets and non-Section 197 intangibles would be subject to appraisal and separate valuation, and that portion of the purchase price assigned to them at their appraised values. The remainder of the purchase price would become the single Section 197 intangible account depreciated over fourteen years. When assets are disposed of from the vintage account, they would be accounted for by merely crediting the proceeds of the sale or disposition to the depreciation reserve account, thereby decreasing available depreciation over the remainder of the fourteen year amortization period. No gain/loss would arise. The remaining available depreciation would merely be decreased by the proceeds or increased by the loss.

Gain would be recognized only after the sum of the depreciation and sales/disposition proceeds credited to the depreciation reserve account exceed the total cost of the acquired intangibles.

Loss would be recognized only after the last intangible asset in the vintage account had been disposed of or had become worthless.

RETROACTIVE APPLICATION

As a matter of fairness and good tax policy, we oppose retroactive application (prior to introduction date) of any tax law, even though our Company would benefit in this instance. However, we understand that the present retroactive application of H.R. 3035 has been structured to be revenue neutral by extending the amortization period from fourteen years to seventeen years if retroactivity is elected. The express goal is to facilitate the closing of open disputes pending with the IRS. We believe the change will accomplish this purpose and we do not object to the retroactive provision as now structured.

We urge that mass asset accounting be adopted by the Committee if it considers H.R. 3035 or other legislation to simplify the tax treatment of intangible assets acquired in business purchases, to eliminate the grossly unfair immediate taxation of gains and deferral of losses. We appreciate the opportunity to submit this statement.

STATEMENT OF THE SOFTWARE PUBLISHERS ASSOCIATION

The Software Publishers Association (SPA) with a membership of more than 900 companies, is the principal trade association of the personal computer software industry. Last year, U.S. personal computer software companies sold nearly $5 billion worth of software products in the United States and Canada These same innovative and highly competitive companies sell nearly 70% of all the software purchased in the countries of the European community and the majority of the software sold around the world.

The SPA wants to commend the committee for seeking to clarify and add certainty to a contentious area of the tax law relating to the tax treatment of acquired intangible assets. However, we are troubled by the scope of the legislation. In particular, it would significantly change the tax treatment of products and companies that are not part of the controversy over goodwill and customer-based intangibles. In its testimony at the October 2, 1991, hearing before the House Ways and Means Committee, the SPA set forth its concerns and wishes to restate them here for the record We will address the bill's application to both discrete, off-the-shelf purchases (non-exclusive licenses) and exclusive software licenses of personal computer software. We will also focus on its potential impact on business acquisitions common to the industry that primarily involve small businesses consisting mainly of software technology.

The changes incorporated into H.R. 3035 and ultimately into the legislation as it currently stands meet most of the software industry's concerns relating to discrete purchases, and we would like to see them maintained should this legislation be passed.

OFF-THE-SHELF-PURCHASES AND EXCLUSIVE LICENSES

Off-the-shelf purchases of personal computer software products should not be drawn into the debate over the tax treatment of intangible assets. No disputes arise over allocating purchase price of software sales or over valuation of the software.

The purpose of the legislation, as stated by the Chairman Rostenkowski in introducing H.R. 3035, is to eliminate uncertainties as to identification and valuation of intangible assets in the context of allocating purchase price to these assets as part of a business acquisition. We agree with Chairman Rostenkowski's statement that legislation is necessary to eliminate the controversy associated with the tax treatment of intangible assets such as customer base by setting uniform, predictable rules for amortizing such assets.

However, extension of such rules to discrete purchases of software products or to exclusive licensing arrangements does not meet the stated goals of the legislation. Computer software products and technology are much more identifiable than such intangibles as goodwill and going concern value. The law in this area has been settled for more than 20 years, and there is no question that in a business setting, the current law deduction for software over five years or less is correct.

Under an IRS revenue procedure, Rev. Proc. 69–21, purchases of software products used in a trade or business may be amortized over five years, or over a shorter useful life, if such a life can be supported, to the satisfaction of the IRS. The determinable life and cost recovery method of amortizing software are thus well-established Again, taxpayers have relied on Rev. Proc. 69–21 for over 20 years; such well-established authority minimizes controversies in this area.

In fact, SPA members are not aware of any cases to date in which the IRS sought to argue that software did not have a determinable useful life. The lack of known controversies in this area suggests that Rev. Proc. 69–21 is working.

The products produced by SPA members have very short lives. Due to the desires of our customers for greater productivity and ease of use, as well as changes in hardware and operating systems, the economic life of personal computer software used in a trade or business is no greater than five years, and it is decreasing.

The rapid increase in business consumer expectations is now forcing manufacturers of personal computer products to create new versions of those products every 12–24 months, and even this cycle is shrinking. Business customers demand that our products be constantly improved Our customers demand that the products perform more tasks efficiently, and thereby help them improve their productivity. At the same time, customers want the new functions to be easy to use.

For example, the first version of Lotus 1-2-3, a spreadsheet program for personal computers, was released in 1983. Since then, it has gone through five major "upgrades," with the latest being in August when Lotus 1-2-3 was released to be used in conjunction with Microsoft Windows, a graphically-oriented user interface that is based on use of a "mouse" to point and click functions rather than combinations of key strokes. As was the case with many of the previous product releases, this latest release of Lotus 1-2-3 involved almost a complete rewrite of the software code, enabling users to take advantage of the new user interface as well as the key stroke functions they were used to in earlier version.

Similarly, Microsoft Word, a word processing program, was originally introduced in October 1983. To date, there have been four new versions and three major upgrades of this product. And Word is not unique either; most Microsoft products are subject to a major release or upgrade every 12–24 months. MS–DOS, which is the system software foremost of the microcomputers in the world, has had six new versions and three major upgrades since its release in 1985. Excel, Microsoft's spreadsheet program, has had no less than two new versions and three major upgrades since it was released in the mid-1980s.

These new versions and upgrades are new products. In a major release, virtually all of the code must be rewritten and many additional lines of code are added A tremendous effort is made to ensure that subsequent releases have the same "look and feel" of previous releases so that the user may expect continuity in the product.

In addition, computer hardware constantly undergoing rapid evolution, presenting customers with the possibility of faster processing speeds, greater memory capacities, additional communication features, and higher quality audio and video capabilities. Each of these improvements presents possibilities to the customers which require new and improved software to achieve. The rapid evolution in hardware technology therefore necessitates rapid creation of new software. Congress recognized the rapid technological obsolescence of computer hardware in 1986 when selecting an appropriate recovery period for computer hardware. It would be appropriate for Congress to consider these same factors when examining the treatment of software, as well.

The impetus to improve software rising from changes in hardware is further compounded by the evolution of computer operating systems and communication software. For example, the advent of the Microsoft Windows operating system with an easier to use, more graphically-oriented user interface has created demand for new products to work within that operating system.

Added to these complexities is the need to market our products internationally. Software products marketed in the United States must, therefore, be recreated to adapt to different languages, cultural norms, operating systems, and hardware preferences.

Applying a 14-year amortization period to individual software purchases most likely will change the existing distribution system for purchases and sales of personal computer software.

It is very likely that software manufacturers would have to consider reverting to the practice of selling software and hardware as single, "bundled" units should H.R. 3035 be enacted in its present form in order to recover software costs over the much more reasonable hardware recovery period of five years. While bundling of software and hardware used to be common, consumer acceptance of the practice of buying software products separate from hardware created substantial economic incentives for independent software companies.

Simply put, amortizing the cost of acquiring software products over 14 years would not solve the problems targeted by the legislation, would not further the goal of simplification, and would reduce the software industry's competitiveness in the global marketplace.

TRADE OR BUSINESS ACQUISITIONS

SPA is also concerned that H.R. 3035 will discourage business acquisitions common to our industry. These acquisitions generally involve businesses that consist primarily of software technology and help ensure that industry products remain at state-of-the-art levels, meet consumer demand, and encourage entrepreneurial innovation.

It is common within the industry, for example, for a company with an otherwise popular product to seek to acquire software technology that could add important features to that product rather than spending the time and money "in-house" to develop those features. Often, these acquisitions involve software companies seeking to acquire software that has been created by small companies consisting of only one or two developers. These types of acquisitions allow larger companies to rapidly meet consumer needs for product enhancements while permitting software entrepreneurs to sell their product and move on to their next project. Obviously, the types of companies that are being acquired have relatively little goodwill or going concern value, and thus do not create significant valuation issues and remain outside the types of tax controversies targeted by the bill.

The increase in the after-tax acquisition cost of such endeavors that would be created under H.R. 3035 naturally will lower the price entrepreneurs will be able to receive for their products, and thus reduce their incentives for innovation. Equally important, foreign companies with more favorable local tax amortization laws will be willing and able to pay a higher purchase price than a U.S. company that is subject to the 14 year rule.

It is important to point out that the number of IRS/taxpayer controversies relating to the acquisition of software is limited, as it demonstrated in the August 1991 GAO report. According to the report, which investigated ongoing IRS cases, disputes involving technology, of which software is a part, were very low in number compared to other intangible assets. This is not surprising given the fact that Rev. Proc. 69–21 ensures that software can be identified and valued, and thus challenges by the IRS relating to the amortization of costs associated with software are virtually nonexistent.

A number of our industry's concerns with the original version of the House bill, H.R. 3035, have been addressed and were incorporated into H.R. 4210, which was vetoed by the President this past March. We would hope that those changes would be maintained in any new version of the bill.

The SPA would like to make additional comments to address some outstanding technical issues. Our technical comments are intended to address the tax on intangibles (specifically, Section 197, computer software) that is contained in H.R. 4210. In particular, SPA has and continues to recommend that subjecting software to Section 197 is anti-competitive in the global environment in which we compete.

TECHNICAL COMMENTS

Section 197(c)(3)(B) defines "computer software" as "any program designed to cause a computer to perform a desired function: except that such term shall not include any data base or similar item." This definition should be expanded to incorporate ". . . and the documentation required to describe and maintain those programs" which is contained in Revenue Procedure 69–21, Section 2.

Printed manuals which accompany the sale of computer software are key elements in allowing the end user to fully utilize the software. Rev. Proc. 69–21 acknowledges this and includes such documentation into the definition of computer software. These manuals are a portion of the total "user education" (UE) package presented to the consumer.

Educating the end user to allow them to interact with the computer software as easily as possible is the purpose of UE. This is accomplished by "on-line" and "off-line" UE. On-line UE is directly written into the software. This includes tutorials which help the end user "get started." Additionally there are "help" keys that explain to the user why or how a particular function may or may not be utilized. No one would argue that this type of assistance should be excluded from the definition of computer software when it is written into the program itself.

Equally important is the off-line UE consisting of manuals and other printed material shipped directly with the product. These materials are as integral to utilizing computer software as the on-line UE. On-line UE often only addresses the most common and basic questions. The printed materials generally address more technical issues.

A second and critical technical point concerns the inclusion of software acquired as part of a trade or business acquisition. SPA believes that Rev. Proc. 69–21 has provided the correct approach to the amortization of computer software when it is

acquired as a portion of a trade or business acquisition. Most computer software has a life of 60 months or less and Rev. Proc. 69–21 recognizes this fact. SPA believes that current law should remain unchanged.

If Congress cannot see its way to apply the rules of Rev. Proc. 69–21, then we suggest that the following changes should be made to the current proposed legislative language. Section 197(e)(3)(B) exempts computer software from Section 197 as long as the assets acquired do not constitute a trade or business or a substantial portion of a trade or business. While the term "trade or business" is used extensively in the Code and Regulations there is no clear definition. Treasury Regulation 1.355–3(b)(2)(ii) and (iii) could be used in the committee reports to clarify this term, rather than the more restrictive and less clear language of Section 1060. SPA recommends a position whereby a trade or business is simply defined as the collection of income and payment of expenses for a period of at least one year with the intent to make a profit.

Also, there is no definition of what constitutes a "substantial portion" of a trade or business. SPA understands that language was added to the conference report for consideration of "borderline" cases. That language states: "It is not intended, however, that the value of the assets acquired relative to the value of the assets retained by the transferor is determinative of whether the acquired assets constitute a substantial portion of a trade of business." While this language is helpful, SPA recommends a "small business" type exception for acquisitions in the $10–20 million dollar range.

Finally, we commend the change made in the conference report language which continues the viability of Treasury Regulation 1.162–3 as it applies to computer software.

CONCLUSION

As the committee is well aware, the software industry plays an important role in the U.S. economy. In particular, the National Critical Technologies Panel stated that "the traditional U.S. lead in software development and applications has been a key factor in maintaining competitiveness in information technology and other vital sectors. The SPA thanks the Committee for the opportunity to submit comments, and looks forward to working with the staff over the coming months to ensure that the final version of this legislation accommodates its original interest of tax simplification without imposing undo and unintended business with the personal computer software industry.

STATEMENT OF THE TELEPHONE AND DATA SYSTEMS, INC.

Telephone and Data Systems, Inc. (TDS), is a group of corporations which includes local exchange telephone companies, cellular telephone companies and radio paging companies. On behalf of itself and its subsidiaries, TDS submits the following comments on the issue of simplifying the tax treatment of purchased intangible assets.

TDS requests the Committee to enact the intangible assets provisions found in the Tax Fairness and Economic Growth Act of 1992 (H.R. 4210). The provisions of section 4501 of H.R. 4210 fairly and efficiently resolved a controversy plaguing taxpayers and the Internal Revenue Service.

We believe that the principal virtue of that bill was its clear and simple treatment of intangible assets.

The General Accounting Office (GAO) addressed intangible asset amortization in a report issued in August 1991. The GAO endorsed the idea that an intangibles statute should have broad coverage. Its authors wrote:

> "allowing amortization of all purchased intangible assets over specified cost recovery periods also would provide taxpayers with an element of certainty that would reduce their administrative burden. Taxpayers would know the periods over which to amortize purchased intangible assets, and they would no longer need detailed analyses to establish asset lives for tax purposes. In such a system, the potential for disputes between IRS and taxpayers would be lessened, thereby reducing IRS' administrative burden as well. Another result would be more consistent treatment of similarly situated taxpayers because the taxpayer's judgment would play a far less significant role in determining amortization deductions than it does under current tax rules."

If enacted H.R. 4210 would have helped the IRS and taxpayers avoid protracted, expensive and needless litigation. We applaud the Senate's endorsement of the principle that most intangible assets should be treated similarly.

The enactment of the intangible asset provisions found in H.R. 4210 would be a significant step in the process of helping American businesses focus on its core problems and relieving it from unnecessary legal and accounting entanglements.

We understand that the United States Telephone Association (USTA) plans to submit written comments on the tax treatment of intangibles. TDS's local exchange telephone companies are members of USTA. We have read a draft of the USTA comments and completely agree with the ideas they are presenting.

We thank the Committee for this opportunity to express our views on this very important subject.

STATEMENT OF THE UNITED STATES TELEPHONE ASSOCIATION

USTA, the United States Telephone Association, is pleased to submit this written statement for the record of the April 28, 1992 Senate Finance Committee Hearing on simplifying the tax treatment of intangible assets acquired in business purchases.

USTA is the primary trade association for the local telephone industry. We represent more than 1,100 telephone companies which provide service to over 99 percent of U.S. phone users. Our member companies range in size from very large regional and independent phone companies to very small rural family owned businesses.

USTA supports the goal of simplifying the tax treatment of intangibles. Amortization of intangible assets is a coordinated issue for the utility industry under the Internal Revenue Service Industry Specialization Program and our members are finding it exceedingly difficult to resolve audits and close back years because of this issue. Our members are also finding it difficult to make current decisions involving intangible assets and to assess contingencies regarding past decisions.

USTA believes that simplifying legislation in the form of section 4501 of the Tax Fairness and Economic Growth Act of 1992 (H.R. 4210), vetoed by the President, is needed now and should be made a part of any tax legislation passed this year. Although the courts have provided guidance regarding the amortization of certain intangibles, judicial guidance is costly and inadequately serves the simplification objective. Additionally, we question whether such guidance will ever be sufficient to cover the full range of intangible assets and whether guidance on legal principles will be sufficient to resolve intangible disputes which appear to focus on appraisals and other fact development. (See, for example, Newark *Morning Ledger Co.* v. *U.S.*, 945 F2d 555 (3rd Cir. 1991), cert granted 60 USLW 3687 (April 6, 1992); *Telecommunications, Inc.*, 95 T.C. 495 (1990), *on appeal* (10th Cir., May 20, 1991)).

USTA supports the provisions regarding the treatment of intangibles in section 4501 of H.R. 4210. The amortization of all acquired intangible assets, including goodwill, over a uniform 14 year period produces certainty and eliminates costly tax controversies and moves U.S. tax law closer to the tax accounting principles of other industrial nations with which we must compete. Although our members obviously will be affected in different ways, we believe that section 4501 is an excellent overall compromise on the tax treatment of acquired intangible assets and properly addresses concerns raised at the House Ways and Means Committee hearings on H.R. 3035, the predecessor to section 4501 of H.R. 4210.

At those hearings, USTA emphasized that software not acquired as part of the acquisition of a trade or business should remain subject to expensing or amortization over a useful life not to exceed 5 years under Revenue Procedure 69–21. We believe this is important to the development of new technology, including telecommunications technology, within the United States and to keep United States software developers and purchasers competitive with foreign developers and purchasers. Fourteen year amortization distorts economic reality when considering the actual useful life of software used in the telecommunications industry. Furthermore, extending the amortization period for software does not further simplification because the tax treatment of software is well established and software is more in the nature of a productive tangible asset subject to valuation than general intangible assets. For these reasons, we support the compromise in section 4501 of H.R. 4210 under which specialized software acquired as part of the acquisition of a trade or business is subject to 14 year amortization and all other software is subject to three year amortization.

USTA also emphasized at the hearings on H.R. 3035 that simplification cannot be achieved unless government licenses and franchises (such as FCC licenses) are

treated in the same manner as general "section 197" intangibles under the bill. The simplification objective otherwise would not be met because taxpayers would argue for maximum allocation of purchase price to goodwill and the IRS would argue for a maximum allocation to government licenses.

Furthermore, government licenses are similar to other intangibles in the fact that they can lose value due to technological obsolescence or changes in market conditions. The Tax Court on two occasions has recognized that government licenses and franchises are similar to private licenses and franchises in this manner. See *Jefferson-Pilot Corp.* v. *Comm'r,* 98 T.C. No. 32 (1992); *Telecommunications, Inc.* v. *Comm'r,* 95 T.C. 495 (1990), *on appeal* (10th Cir., May 20, 1991). For these reasons, we support the position in section 4501 of H.R. 4210 which affords uniform treatment of government licenses and franchises with general intangible assets.

In conclusion, USTA supports the prompt passage of a bill simplifying the tax treatment of intangibles in the form of section 4501 of H.R. 4210 provided it retains its present treatment of computer software and government licenses. We believe that section 4501 is a reasonable compromise to the many complex issues surrounding the tax treatment of acquired intangible assets and would like to see intangibles simplification adopted in this form as soon as possible.

STATEMENT OF THE UNITED STATES TRADEMARK ASSOCIATION

The United States Trademark Association ("USTA") appreciates the opportunity to express its views on amending the Internal Revenue Code ("IRC") to simplify and make more consistent the tax treatment of intangible assets particularly as it bears on trademarks. USTA testified on this important and timely matter before the House Ways and Means Committee during its October, 1991 hearings on H.R. 3035, legislation which was eventually incorporated into H.R. 4210 as adopted by Congress. USTA hopes that the Senate Finance Committee will recognize the Association as a resource on those taxation issues which bear on the integral role of trademarks to commerce both here and abroad.

USTA is a 114 year-old not-for-profit association with a membership of approximately 2400 corporations, package design firms, law firms, and professional associations from across the United States and eighty countries committed to the preservation and promotion of trademarks. USTA's membership, which crosses all industry lines and includes both manufacturers and retailers, is united in the goals of maintaining effective commerce, promoting the interests of consumers, and encouraging free and effective competition. Because of its diverse membership and as a matter of policy, USTA does not take positions on matters of public policy unless the underlying principles and functions of trademarks or the trademark system are directly involved.

Under current law, needless conflicts exist with regard to that portion of the purchase price allocable to amortizable intangibles and to the appropriate method and period for recovering their costs. These conflicts unnecessarily waste the resources of the U.S. economy. Consequently, the present tax treatment of those persons acquiring or renewing trademarks and trade names in lump sum purchase price transactions, requires an overhaul in order to eliminate the increasing number of controversies between trademark owners and the Internal Revenue Service. However, just as important an aim, and even more consequential, is providing appropriate treatment for the expenses of self-created marks not currently deductible.

Thus, the Association supports language which would streamline and, where feasible, make consistent the tax treatment accorded both acquired and self-created trademarks as well as to provide objective standards comparable to those for tangible assets.

THE IMPORTANCE OF THE AMORTIZATION OF TRADEMARK EXPENSES

The amortization of trademark expenses is a significant and necessary factor in the free flow of commerce. Although trademarks are generally recognized as words and/or symbols used to identify and distinguish goods and services, their extraordinary impact on our nation's U.S. Trademark Association economic well-being is too frequently unappreciated. Without trademarks and trade names, there could be no effective means to educate consumers as to the choices available to them. Thus, our remarkably efficient system for the ordering and distribution of goods and services would be eradicated. Because current tax policy fails to fully recognize these benefits to our economy, benefits which are responsible for producing consistent revenue streams, it presses trademark owners into tax-based business decisions that detract from this efficient system.

Additionally, legislation which would provide for greater simplification and consistency would aid U.S. businesses in the international marketplace. Many U.S. based corporations find themselves disadvantaged when seeking to expand their market share or acquire additional businesses and marks because competing nations' tax statutes may be more favorable to businesses incorporated under their laws. Additionally, these statutes offer clearer, more uniform procedures for acquisitions both in their home countries and, more importantly, in the United States. Because of inconsistent and, at times, seemingly arbitrary tax treatment of trademarks, we understand that present IRS procedures and regulations may have had a chilling effect on potential acquisitions by U.S. based businesses. Trademark owners which operate both large and smaller enterprises would benefit enormously by a more level playing field and the assurance that a desired acquisition will not run afoul of our tax laws.

ENCOURAGEMENT OF NEW, SMALL AND ONGOING BUSINESSES

For an initiative to fully serve trademark owners it must look to the needs of new (and thus typically small) and ongoing business concerns. The introduction, deliberation and consideration of an intangible tax simplification measure would present a splendid opportunity to provide that all trademark-related expenses not otherwise eligible as a current deduction may also be made eligible for the agreed amortization period (including those previous expenses not already amortized under existing law for the remaining balance of the legislation's amortization period). For purposes of inclusion under IRC section 197, "trademark-related expense" should be defined as those expenditures that are directly connected with the acquisition, protection, renewal (whether federal, state or foreign) and defense of the mark, chargeable to a capital account, whether or not part of the consideration or purchase price paid for the mark.

Currently, the IRC recognizes no amortization of trademark expenses incurred in ongoing business activities except for pre-1986 Tax Act assets and IRC Section 1253 trademark transfers. If it is determined that the transferor retains certain rights in the mark, IRC Section 1253(d) enumerates the proper treatment to the transferee in those cases where payment is made on either a contingent or noncontingent basis. Depending on the size of the payment, it is subject to either a ten or twenty-five year amortization schedule [IRC §1253(d)(2) or §1253(d)(3)(B)(i)]. (The deductibility of contingent payments is detailed in IRC §1253(d)(1)(B)).

The amortization of trademark expenses in acquisitions and, even more importantly, in the daily activities of new and ongoing business concerns, coupled with the brand loyalty created by trademarks will help ensure that businesses will continue to invest significant funds not U.S. Trademark Association only on maintaining or improving a certain consistency of quality but also on effective consumer oriented package design, and on related services to maintain and enhance their products' reputations and consumer recognition.

On the other hand, failure to address this issue accommodates a policy which encourages the buying and selling of businesses as more important to the economy of the United States than the development and long-term growth of dedicated and well-managed industrial and commercial enterprises that historically have provided more employment and stability to our local communities.

Further, neglecting to make trademark-related expenses eligible for amortization treatment seriously lessens and may even remove the impetus to not only maintain and protect U.S. based marks but also to register the mark by those trademark owners most in need of protection, thereby undermining a primary purpose of the federal trademark law. Thus, it is absolutely vital that the Committee recognize and account for the long overdue need of treating trademark and trade name expenses for new and ongoing business activities under the same rules of amortization as expenses of acquired trademarks and trade names.

SUMMARY

USTA not only acknowledges but emphasizes the differences between trademarks and other forms of intellectual property. Nevertheless, the Association also is aware that those differences make it more difficult to both quantify the precise benefits that trademarks and trade names convey to their owners and consumers and to calculate their exact value for tax purposes. Nevertheless, these benefits are immense and are becoming more so both to trademark owners and their licensees as well as our local and national economies.

As the only organization devoted exclusively to ensuring that trademarks continue to serve the trademark community and consumers, USTA is pleased to support the efforts of this Committee in obtaining its passage and eventual enactment into law of a bill consistent with these remarks.