A TRANSACTIONAL GUIDE TO NEW CODE SECTION 197

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In this article, Levin and Rocap analyze new section 197, which generally mandates 15-year straight-line amortization where goodwill and other intangibles are purchased in a taxable asset acquisition or a taxable stock acquisition that is treated as an asset acquisition as a result of a section 338 election, and where a covenant not to compete is acquired in connection with a stock purchase with no section 338 election.

This mandatory 15-year amortization for purchased intangibles is significantly more favorable than prior law for previously nonamortizable intangibles like goodwill, but significantly less favorable than prior law for previously short-lived intangibles like covenants not to compete.

Section 197 divides intangibles into four different categories. First, certain intangibles — including off-the-shelf computer software, interests in tangible property leases, interests in debt obligations — are entirely excluded from section 197. Second, certain other intangibles — including customized computer software, contract rights to receive tangible property or services, patents, copyrights, films, and mortgage servicing rights — are covered by section 197 only where there is a related acquisition of *assets* constituting a trade or business. Third, covenants not to compete are covered by section 197 where there is a related acquisition of a business by a purchase of either assets or stock. Fourth, certain other intangibles — including goodwill, workforce in place, customer-based intangibles, governmental licenses, franchises, trademarks, trade names and know-how — are, with limited exceptions, always covered by section 197.

The authors note that section 197's "antichurning" rules, which they find to be hash — and extremely complicated — may prevent taxpayers from amortizing goodwill (and other assets that would not be amortizable but for section 197) where the seller and purchaser of assets are related. Overlapping ownership of more than 20 percent (either immediately before or immediately after the sale) may cause the antichurning rules to apply.

New section 197 generally applies to acquisitions closing after August 10, 1993. Taxpayers may, however, elect to apply section 197 to all acquisitions made after July 25, 1991, by the taxpayer and any 50-percent-or-more related person. Such a retroactive election may produce unanticipated adverse effects on affiliates bound by the election. Taxpayers not making (and not bound by) a retroactive election may elect to have the section 197 rules not apply to any acquisition subject to a binding written contract in effect on August 10, 1993.

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I. Summary

New Internal Revenue Code section 197, enacted as part of the Omnibus Budget Reconciliation Act of 1993, fundamentally changed the tax rules for amortizing purchased intangibles.[1] In general, new section 197 mandates 15-year straight-line tax amortization for all purchased intangibles, which is:

(a) significantly more favorable than prior law for previously nonamortizable intangibles like goodwill, but

(b) significantly less favorable than prior law for previously short-lived intangibles like covenants not to compete.

This article explains the new rules and discusses their practical impact on business acquisitions.

Section 197 principally affects intangibles purchased as part of a business acquisition. However, as discussed in II below, section 197 applies to the purchase of several types of intangibles (such as customer lists) even if not purchased as part of a business acquisition.

New section 197 generally applies to all transactions closed after August 10, 1993, with two exceptions (as discussed in V below):

First, a taxpayer can elect to apply section 197 retroactively to an acquisition closed after July 25, 1991. However, such a retroactive election covers all acquisitions by the taxpayer and all related entities (defined very broadly — generally 50 percent or more by vote or value). Because a retroactive election by a small, partially owned, noncontrolled subsidiary or affiliate binds all related taxpayers, it is essential to prevent a retroactive election that would be disadvantageous, taking into account all affected taxpayers.

Second, a taxpayer can elect out of section 197 for a transaction closed after August 10, 1993, but for which a binding contract was in effect on August 10, 1993.

II. Scope and Effect

A. Transactions and Assets to Which Applicable

In summary, new section 197 applies to (a) any stepped-up basis (SUB) acquisition and (b) any carryover basis (COB) acquisition with a separately purchased covenant not to compete (or certain other separately purchased intangibles). Thus, section 197 applies in each of the following cases:

(a) SUB — Intangible assets acquired in (i) a taxable purchase of assets (or a taxable forward merger) or (ii) a taxable purchase of stock (or a taxable reverse merger) with a section 338 election.

(b) COB — Covenants not to compete (and certain other intangibles) acquired (generally from target's shareholders) in connection with a stock purchase with no section 338 election.

If purchaser (P) purchases the stock of target corporation (T) with no section 338 election, T retains a COB for tax purposes (i.e., the tax basis of T's assets does not change), even though T's assets are written-up for financial accounting purposes. Accordingly, section 197 has no effect on T's assets in a stock acquisition with no section 338 election (although, as noted in (b) above, section 197 would apply to any covenant not to compete entered into in connection with the purchase of T's stock).

When section 197 applies to an acquisition, the general rule is that all intangibles acquired in the acquisition are amortized on a straight-line basis over 15 years. Among the types of intangibles covered by this 15-year amortization rule are:

(a) Goodwill and going concern value.

(b) Workforce in place.

(c) Customer lists, favorable contracts with customers (even those with a limited life less than 15 years), and other customer-based intangibles (but not receivables for past sales of goods or services).

(d) Favorable contracts with suppliers of goods or services (even those with a limited life less than 15 years) and other supplier-based intangibles.

(e) Business books and records and any other information base.

(f) Patents, copyrights, formulas, processes, know-how, designs, and similar items.

(g) Computer software.

(h) Franchises, trademarks and trade names.

(i) Licenses, permits and rights granted by governmental agencies.

(j) Covenants not to compete and similar arrangements.[2]

[1]All statutory references are to the Internal Revenue Code of 1986, as amended.

[2]Under section 197 (as under prior law), where the amount allocated to a noncompete covenant is unreasonable, the excess is reallocated to the other assets purchased. Hence where P purchases stock with no section 338 election and also purchases a noncompete, only the reasonable value of the noncompete is amortizable over 15 years; the excess is reallocated to the stock and is nonamortizable.

Similarly, where P purchases T's stock and pays an excessive amount to T's former shareholders for consulting services or to rent property, the amount in excess of fair value is reallocated to the stock and hence is nonamortizable.

A series of complex exclusions of specific intangibles under specified circumstances is discussed at II.B. below.

If an asset subject to section 197 is subsequently sold at a loss or becomes worthless before the end of the 15-year amortization period, and P continues to hold any other section 197 assets acquired in the same transaction or series of related transactions, P will not be permitted to deduct the loss; rather, P's unrecovered basis in the asset which was sold or became worthless continues to be amortized over the 15-year period.[3] In the case of a covenant not to compete, this loss disallowance rule applies — even if the covenant was the only section 197 asset acquired — unless P disposes of its entire interest in the business in connection with which the covenant was obtained.[4]

Example (1): SUB acquisition. P purchases all of T's assets for $10 million. P allocates the purchase price as follows:

Trademark	$1.5M
Goodwill	3.0M
Nonsection 197 assets	5.5M
Total	$10.0M

Under section 197, P is allowed amortization deductions of $100,000 per year with respect to the trademark and $200,000 per year with respect to the goodwill.

At the end of the fourth year following the acquisition, when P's remaining tax basis in the trademark is $1.1 million, P abandons the trademark. P is not permitted to claim a $1.1 million loss for the abandoment of the trademark unless P can also establish that the goodwill acquired from T has become entirely worthless (i.e., P has abandoned the entire business acquired from T). Rather, P will be required to continue to amortize the cost of the abandoned trademark over section 197's 15-year amortization period.

Example (2): COB acquisition. P purchases all of T's stock for $9 million and makes no section 338 election. P also pays T's sole shareholder (or one or all of T's several shareholders) $1 million for a three-year covenant not to compete.

Under section 197, P is allowed amortization deductions of $66,667 per year with respect to the covenant.

At the end of three years when the covenant expires, P is not permitted to deduct the unamortized 12/15 of the covenant purchase price unless P disposes of its entire interest in T's business (assets and stock); rather, P would continue to amortize the price of the expired covenant over the remainder of section 197's 15-year amortization period (or, if earlier, when P disposes of its entire interest in T's business).

[3]Section 197(f)(1)(A).

[4]Section 197(f)(1)(B).

B. Treatment of Specific Intangibles

Intangibles fall into four categories for section 197 purposes:

- Intangibles specifically excluded from section 197 under all circumstances.
- Intangibles covered by section 197 only where there is a related purchase of *assets* (including a purchase of stock with a section 338 election) constituting a business or a substantial portion of a business.
- Intangibles covered by section 197 only where there is a related purchase of a business by an acquisition of *assets or stock.*
- Intangibles covered by section 197 in all circumstances.

1. Entirely Excluded Intangibles

a. Off-the-shelf computer software. Section 197 never applies to computer software (even when acquired as part of a larger business) if the software (a) is readily available for purchase by the general public, (b) is subject to a nonexclusive license, and (c) has not been substantially modified.[5] Such computer software excluded from section 197 is amortizable on a straight-line basis over a 36-month period.[6]

b. Interests in tangible property leases. Section 197 never applies to the interest of a lessor or lessee in an existing lease of real or tangible personal property (even when acquired as part of a larger business).[7] In general, the value of the lease (to the lessor or lessee) is amortizable over the remaining term of the lease. If, however, a taxpayer purchases the underlying property together with a favorable lease to a tenant, the 1993 act requires that the purchase price allocable to the favorable lease be treated as part of the purchase price of the underlying property rather than as a separately amortizable asset.[8]

Example (1): P assumes T's lessee position. P purchases all of T's assets, including T's rights *as tenant* under an assignable real estate lease (or equipment lease) at a below-market rental. The amount of purchase price allocable to the favorable leasehold is not a section 197 15-year asset, but rather is amortizable by P over the remaining term of the lease.

Example (2): P assumes T's lessor position. P purchases all of T's assets, including T's rights as *landlord* under a real estate lease (or an equipment lease) at an above-market rental. The amount of purchase price allocable to the favorable lease (as landlord) is not a section 197 15-year asset. However, in this case, the 1993 act requires P to include the basis assigned to the favorable lease (as land-

[5]Section 197(e)(3)(A)(i).

[6]Prior to the 1993 act, computer software was generally amortizable over a 5-year period, unless a shorter useful life could be established. Section 167(f)(1)(A), adopted in the 1993 act, provides a mandatory, shortened amortization period for nonsection 197 computer software.

[7]Section 197(e)(5)(A).

[8]Section 167(c)(2).

lord) as part of P's tax basis in the real estate (or equipment) which is subject to the lease. Hence, the value of the favorable lease (as landlord) would be recovered by P as depreciation on the real estate (or equipment).

c. Interests in debt obligations. Section 197 never applies to the interest of a borrower or lender in an existing debt obligation (even when acquired as part of a larger business).[9] (This section 197 exclusion does not apply, however, to the asset represented by the deposit base of a financial institution, which is treated as a section 197 asset.)

Example (1): P assumes T's borrower position. P purchases all of T's assets and assumes T's liabilities, including T's debt to a third party bearing a below-market interest rate. P may amortize the portion of the purchase price allocable to the favorable financing over the remaining term of the debt.

Example (2): P purchases T's lender position. P purchases all of T's assets, including a debt instrument held by T (i.e., a third party's debt to T) bearing an above-market interest rate. P may amortize the portion of the purchase price allocable as premium on the debt instrument over the term of the instrument under the bond premium rules of section 171.

d. Franchises, trademarks and trade names requiring contingent serial payments. Section 197 never applies to a franchise, trademark or trade name (even when acquired as part of a larger business) if the purchase price P is paying for such rights consists of payments which are:

(a) contingent on the productivity, use or disposition of the right, *and*

(b) payable not less frequently than annually for the full period P has the right to use the franchise, trademark and/or trade name, *and*

(c) substantially equal in amount (or determined under a fixed formula).[10]

Payments meeting the above requirements are currently deductible as paid or incurred.[11]

A purchased franchise, trademark or trade name where the purchase price is a fixed amount or one or more contingent payments not meeting the requirements set forth above is always a section 197 15-year asset, as described in II.A.4.d. below.

e. Financial interests. Section 197 never applies to:

(a) an interest in a corporation, partnership or trust, *or*

(b) an interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract.[12]

f. Interests in land. Section 197 never applies to an interest in land.[13]

g. Fees for professional services and transaction costs in tax-free contributions and reorganizations. Section 197 never applies to fees for professional services or transaction costs incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C (i.e., tax-free corporate contributions under section 351 and tax-free reorganizations under section 368).[14] This provision is intended to "codify the [Supreme] Court's decision [in *INDOPCO v. Commissioner*] which prohibits corporations from deducting legal and other professional expenses which are directly incurred in corporate buyouts and takeovers."[15]

In certain instances, this section 197 exclusion could lead to a pro-taxpayer result. Specifically, where P acquires T's assets in a tax-free reorganization, it appears that P can add to the basis of the T assets the professional fees that P incurs in connection with the acquisition. By excluding these professional fees from the definition of a section 197 intangible, and thus from the mandatory 15-year amortization period, the provision may enable P to recover its professional fees faster (i.e., to the extent P allocates the fees to assets with relatively short depreciable lives).

Moreover, by its terms this section 197 exclusion applies only to a tax-free or partially tax-free corporate transaction, and does not apply either to a fully taxable acquisition or to a transaction not involving corporations (e.g., a taxable or tax-free acquisition by a partnership).

2. Intangibles covered by section 197 only when there is a related acquisition of the assets of a business[16]

a. Customized computer software. Customized computer software (i.e., software which does not meet the automatic exclusion for off-the-shelf commercial software, as described in II.B.1.a. above), is covered by section 197 *only* when there is a related acquisition of *assets* constituting a business or a substantial portion of a business.[17] The cost of separately acquired soft-

[9]Section 197(e)(5)(B).
[10]Section 197(f)(4)(C).
[11]Section 1253(d)(1).
[12]Section 197(e)(1).
[13]Section 197(e)(2).
[14]Section 197(e)(8).
[15]Amendment No. 3168 (introduced by Sen. Mitch McConnell, D-Ky.), *Daily Congressional Record*, September 24, 1992, at S 14888.
[16]It appears that the exclusions described in this II.B.2. are not rendered inapplicable by a related acquisition of a business that was structured as a *stock* acquisition (with no section 338 election), i.e., that the II.B.2. exclusions are rendered inapplicable only by a related *asset* acquisition (including a stock acquisition treated as an asset acquisition due to a section 338 election). Contrast the statutory language and committee report descriptions of section 197(e)(4) (describing the acquisition of *assets* constituting a business) and of section 197(d)(1)(E) describing the acquisition, directly or indirectly, of an *interest* in a business).
[17]Section 197(d)(1)(C)(iii) and (e)(3)(A)(ii).

ware excluded from section 197 is amortizable over 36 months.[18]

b. Contract rights to receive tangible property or services. A right to *receive tangible property* or *services* either under a contract or under a governmental grant (e.g., a right to purchase raw materials on favorable terms) is covered by section 197 *only* when there is a related acquisition of *assets* constituting a business or a substantial portion of a business.[19] In general, the cost of such separately acquired favorable contract or governmental right to receive tangible property or services is amortized over the term of the contract (as under current law).

Example (1): T sells P a valuable agreement to receive property from a third party. P purchases only one asset from T: T's valuable contract to buy widgets from Bigco at a bargain price. As to P, this valuable agreement to receive tangible property (not purchased as part of the acquisition of a business) is **not** covered by section 197.

Example (2): T sells P a valuable right to receive services from a third party. P purchases only one asset from T: T's valuable contract to receive services from individual A at a bargain price. Same result as Example (1).

Example (3): P purchases assets constituting a business from T. Same facts as Examples (1) and (2), except that P also buys from T assets constituting a business. The valuable contract to *receive* property (from Bigco) or services (from individual A) which P purchased from T is covered by section 197.

Example (4): T sells P a valuable agreement to supply property to a third party. P purchases only one asset from T: T's valuable contract to *supply* widgets to Bigco at an above-market price. The valuable contract to *supply* property to Bigco is covered by section 197 even though there is no related acquisition of assets of a business, because the section 197 exclusion applies only to a contract to *receive* property or services (see II.B.4.a. below).

Example (5): P purchases T's stock plus a valuable contract from T's parent. T-Parent owns (i) all of T's stock and (ii) a valuable contract to buy widgets from T at a below-market price. P purchases from T-Parent (i) all of T's stock (with no section 338 election) and (ii) the valuable contract to buy widgets from T. It appears that, as to P, the valuable contract to *buy* widgets is not covered by section 197, because there is no related acquisition by P of *assets* constituting a business.

c. Patents or copyrights. An interest in a patent or copyright is covered by section 197 *only* when there is a related acquisition of *assets* constituting a business or a substantial portion of a business.[20] In general, the cost of the separately acquired patent or copyright is amortized over the remaining legal life of the patent or copyright *or* (if shorter) its economically demonstrable useful life (as under current law).

d. Films, recordings, books and similar rights. An interest in a film, sound recording, video tape, book or other similar property is covered by section 197 *only* when there is a related acquisition of *assets* constituting a business or a substantial portion of a business.[21] The cost of such separately acquired assets is amortizable under the income forecast or other depreciation method (as under current law).

e. Mortgage servicing rights. A right to service debt secured by residential real property is covered by section 197 *only* when there is a related acquisition of *assets* constituting a business or a substantial portion of a business.[22] The 1993 act establishes a mandatory nine-year straight line amortization for such separately acquired mortgage servicing rights.[23] A purchased right to service debt other than debt secured by residential real property is covered by section 197 (as a customer-based intangible) even if there is no related acquisition of assets of a business (see II.B.4.a. below).

f. Most self-created intangibles. An intangible "created by the taxpayer" is covered by section 197 only when there is a related acquisition of *assets* constituting a business or a substantial portion of a business.[24] However, this exclusion does not apply to:

(a) a license, permit or other right granted by a governmental agency,

(b) a covenant not to compete, or

(c) a franchise, trademark or trade name.[25]

For example, capitalized costs of creating package designs, developing internal-use computer software, training employees, developing favorable contracts with customers and suppliers, and arranging financing are self-created intangibles not covered by section 197 (unless incurred in connection with a related acquisition of assets constituting a business or a substantial portion of a business). The 1993 Conference Report (at 684) states that an intangible that is owned by a taxpayer is treated as a self-created intangible if it is produced for the taxpayer by another person under a contract entered into prior to the production of the intangible.

g. Regulatory authority to exclude other contract rights. The Treasury is authorized to issue regulations excluding from section 197 a contract or right granted by a governmental agency (when there is no related acquisition of *assets* constituting a business or substantial portion of a business) if:

(a) the right has a fixed duration of less than 15 years, *or*

(b) the right is fixed as to amount and, without regard to section 197, would be recoverable under

[18]Section 167(f)(1) (as amended by the 1993 act).

[19]Section 197(d)(1)(C)(v), (d)(1)(D), and (e)(4)(B).

[20]Section 197(d)(1)(C)(iii) and (e)(4)(C).

[21]Section 197(d)(1)(C)(iii) and (e)(4)(A).

[22]Section 197(d)(1)(C)(iv) and (e)(7).

[23]Section 167(f)(3).

[24]Section 197(c)(2).

[25]Section 197(c)(2)(A).

a depreciation method similar to the unit-of-production method.[26]

3. Intangibles covered by section 197 only when there is a related acquisition of the assets or stock of a business

a. Covenants not to compete. A covenant not to compete is covered by section 197 only when there is a related purchase of a business (or a substantial portion of a business) by a purchase of either *assets* or *stock* (with or without a section 338 election).[27] The 1993 Conference Report states that:

> an arrangement that requires the former owner of an interest in a trade or business to continue to perform services . . . that benefit the trade or business is considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner . . . exceeds the amount that represents reasonable compensation for the services actually rendered . . . by the former owner. As under present law, to the extent that the amount paid or incurred . . . represents additional consideration for the acquisition of stock in a corporation, such amount is . . . included as part of the acquirer's basis in the stock.

4. Intangibles always covered

Intangibles described in II.A. above, but not specifically excluded from section 197 as described in II.B.1., 2., and 3. above, are always covered by section 197 even when there is no related acquisition of assets constituting a business or a substantial portion of a business. Some of the intangibles falling into this category — such as goodwill, going concern value, workforce in place, and business books and records — while theoretically covered by section 197 in all situations, are unlikely to be purchased except as part of an acquisition of the assets of a business.[28] The following types of intangible assets, however, are commonly purchased separately from an acquisition of business assets and are now covered by section 197's 15-year amortization rule.

a. Customer-based intangibles. Customer-based intangibles are always subject to section 197, unless they fall within *either:*

(a) the limited exception for mortgage servicing rights not acquired as part of a larger acquisition of assets (as discussed at II.B.2.e. above) *or*

(b) the limited exception for self-created intangibles not acquired as part of a larger acquisition of assets (as discussed at II.B.2.f. above).[29]

Among the assets falling into this category are lists or other information with respect to current or prospective customers and contractual or other relationships with customers (e.g., customer lists, circulation base, core deposits, insurance in force, and valuable contracts to supply customers with goods and/or services).

b. Certain supplier-based intangibles. Supplier-based intangibles are always covered by section 197, unless they fall within *either:*

(a) the limited exception for contractual rights to receive *tangible property* or *services* not acquired as part of a larger acquisition of assets (as discussed at II.B.2.b. above) or

(b) the limited exception for self-created intangibles not acquired as part of a larger acquisition of assets (as discussed at II.B.2.f. above).[30]

c. License, permit or right granted by government. A license, permit or right granted by a governmental unit or agency or instrumentality is always covered by section 197 (even if the right is granted for an indefinite period), unless it falls within one of the following categories:

(a) the limited exception for rights to *receive tangible property* or *services* not acquired as part of a larger acquisition of assets (as discussed at II.B.2.b. above) *or*

(b) the exception for patents and copyrights not acquired as part of a larger acquisition of assets (as discussed at II.B.2.c. above) *or*

(c) the limited exception for a franchise where the purchase price consists of contingent serial payments based on a uniform formula throughout the life of the right (as discussed at II.B.1.d. above).[31]

Among the assets falling within this always-covered-by-section 197 category are the costs of acquiring a liquor license, a taxi license, an airport landing or takeoff right, a regulated airline route, or a television or radio broadcast license.

d. Franchise, trademark or trade name. A franchise, trademark or trade name is always covered by section 197 unless it falls within the limited exception where the purchase price consists of contingent serial payments based on a uniform formula throughout the life of the right (as discussed at II.B.1.d. above).[32] Under prior law, a franchise, trademark or trade name which did not fall into this exception was amortizable under section 1253 over 10 years (if the purchase price did not exceed $100,000) or 25 years (if the purchase price exceeded $100,000), but only if the transferor of the right retained a "significant power, right, or continuing interest." This 10 year/25 year section 1253 amortization has been repealed.

e. Formulas, processes, designs, know-how and similar items. Formulas, processes, designs, know-

[26]Section 197(e)(4)(D).

[27]Section 197(d)(1)(E).

[28]A purchase of goodwill may, however, occur in connection with a purchase of a trademark, even if such purchase is not part of the acquisition of a substantial portion of a business, since federal law generally does not permit assignment of a trademark without a transfer of the related goodwill. 15 U.S.C. section 1060.

[29]Section 197(d)(1)(C)(iv), (e)(7), and (c)(2).

[30]Section 197(d)(1)(C)(v), (e)(4)(B), and (c)(2).

[31]Section 197(d)(1)(D), (e)(4)(B), (e)(4)(C), and (f)(4)(C).

[32]Section 197(d)(1)(F) and (f)(4)(C).

how and similar items are always covered by section 197, unless they fall within *either:*

(a) the limited exception for off-the-shelf computer software (as discussed at II.B.1.a. above), or

(b) the limited exception for customized computer software not acquired as part of a larger acquisition of assets (as discussed at II.B.2.a. above), or

(c) the limited exception for patents or copyrights not acquired as part of a larger acquisition of assets (as discussed at II.B.2.c. above), or

(d) the limited exception for certain self-created intangibles not acquired as part of a larger acquisition of assets (as discussed at II.B.2.f. above).[33]

III. Limitation: Related Purchaser and Seller

A. General Description of Limitation

Where P is related to T (either immediately before or immediately after the acquisition, including a relationship arising as a result of T or T's owners acquiring an equity interest in P in connection with the sale to P), "antichurning rules" may prevent P from claiming amortization deductions for those intangibles which would not be amortizable without section 197.[34] The antichurning rules contain several key features.

First, the antichurning limit on amortization applies only to goodwill, going concern value, and any other section 197 intangible which would not be amortizable without section 197 (i.e., any intangible which does not have a reasonably ascertainable useful life).[35] This will have the unfortunate effect of extending into the future the same disputes as existed under prior law regarding whether intangibles such as customer lists and employee workforce in place would, based on the facts of the particular case, be amortizable if section 197 did not exist. However, once it is determined that an intangible would have been amortizable under old pre-section 197 law, the antichurning limit will not apply and the intangible will be amortized over 15 years under the general section 197 rule.

Second, the antichurning limitation on amortization applies only if P and T are related under one of several alternative tests. Unfortunately, the rules for determining whether parties are related for this purpose (discussed in III.B. below) are extremely broad and complicated. In general, however, overlapping ownership of more than 20 percent (immediately before or immediately after the transaction) may cause the antichurning limitation to apply.[36]

Third, the antichurning limitation on amortization applies only if T (or a person related to T) held the intangible on or before August 10, 1993.[37]

In general, if the antichurning limitation on amortization applies, P is not permitted to claim any amortization deduction for the goodwill or goodwill-like intangible.[38] As discussed in III.C. below, where certain conditions are met, the seller may elect to pay increased tax on the sale as the price for exempting P from the antichurning rules (in which case P will qualify for 15-year section 197 amortization).

The antichurning rules generally apply only to assets that existed on August 10, 1993.[39] However, the loss of section 197 amortization under these rules is not limited to the value of the goodwill or goodwill-like intangible on August 10, 1993. Accordingly, the rules will continue to serve as a serious trap for the unwary far into the future, even if only a small portion of the value of the goodwill or goodwill-like intangible is attributable to the pre-August 11, 1993 period.

B. Related Party for Antichurning Limit

The definition of a related party for purposes of the antichurning rules is highly complicated, because the definition is based on cross-references to three different and complex statutory related-party rules, with those rules then further modified for purposes of applying them to section 197.[40] Common acquisition patterns where the related party rules would apply are described below.

Because section 197 incorporates by reference three different related party rules, some transactions may potentially fit into more than one of the categories described below. A transaction is covered by the antichurning rules if it runs afoul of any one of these rules.

1. Individual sells assets to C or S corporation; the individual and related persons own more than 20 percent by value of the corporation's stock

Individual A sells the assets of his sole proprietorship to corporation P (either a subchapter C or S corporation) and, in connection with the sale, A acquires 21 percent of P's stock. The antichurning rules apply since an individual is treated as related to a subchapter C or S corporation if the individual (directly or through the application of the constructive ownership rules described below) owns more than 20 percent *by value* of the corporation's stock immediately after the transaction.[41] For purposes of measuring the value of the corporation's stock, all of the corporation's outstand-

[33]Section 197(d)(1)(C)(iii), (e)(3)(A)(i), (e)(3)(A)(ii), (e)(4)(C), and (c)(2).

[34]Section 197(f)(9).

[35]Section 197(f)(9)(A).

[36]Section 197(f)(9)(C).

[37]The antichurning limitation on amortization also applies where a person (other than P) who held the section 197 intangible before August 11, 1993 continues to have the right to use the intangible after P's acquisition of the asset.

[38]Section 197(f)(9)(A).

[39]Section 197(f)(9)(A)(i).

[40]Section 197(f)(9)(C).

[41]Sections 197(f)(9)(C)(i) and 267(b)(2).

ing stock (common and preferred, whether or not voting) is taken into account.[42]

Under the constructive ownership rules that apply in this situation[43] (and in the situations described in B.2. and 3. below, but not always in the situations described in B.4. through 7. below):

(a) A is treated as owning his proportionate share of any P stock owned indirectly through another corporation, partnership or trust, and

(b) A is treated as owning any P stock owned (directly or indirectly through another corporation, partnership or trust) by any member of A's family[44] or by any partner of A.[45]

The constructive ownership rules that apply in this situation do not, however, treat A as owning P stock that A could acquire through the exercise of an option, warrant or convertible debt.[46]

2. S corporation sells assets to C or S corporation; or C corporation sells assets to S corporation; more than 20 percent common ownership of buying and selling corporations

T-SCo[47] sells all of its assets to P or P-SCo; T-SCo's shareholders already own 21 percent of P's stock or, in connection with the sale, T-SCo's shareholders acquire 21 percent of P's stock. Alternatively, T sells all of its assets to P-SCo; T's shareholders already own 21 percent of P-SCo's stock or, in connection with the sale, T's shareholders acquire 21 percent of P-SCo's stock. Both of these transactions would be subject to the antichurning rules since, for this purpose, an S corporation is treated as related to a C or S corporation if the same persons (directly or through the application of the constructive ownership rules described in B.1. above) own more than 20 percent *by value* of the stock of both corporations.[48]

For reasons that flow from history, sales between two C corporations do not appear to be covered by this 20-percent-related-party rule. Rather, such sales appear to be covered only by the 50-percent-related-party rules described in B.4. through 7. below. The statute is not, however, wholly clear in this regard. See B.4. below for discussion of the risk that two C corporations might be considered related for purposes of the antichurning rules if either corporation owns *more than 20 percent* of the stock, by vote or by value, of the other corporation.

3. Partnership sells assets to C or S corporation; or C or S corporation sells assets to partnership; more than 20 percent common ownership of entities

T-Partnership sells all of its assets to P or P-SCo; T-Partnership's partners already own 21 percent of P's or P-SCo's stock or, in connection with the sale, T-Partnership's partners acquire 21 percent of P's or P-SCo's stock. Alternatively, T or T-SCo sells all its assets to P-Partnership; T's or T-SCo's shareholders already own 21 percent of P-Partnership's capital or profits or, in connection with the sale, T or T-SCo or persons owning more than 20 percent of T's or T-SCo's stock acquire 21 percent of P-Partnership's capital or profits. All of these transactions are subject to the antichurning rules since a partnership is treated as related to a subchapter C or S corporation if the same persons (directly or through application of the constructive ownership rules described in B.1. above) own more than 20 percent of the capital or profits interest in the partnership and more than 20 percent *by value* of the corporation's stock.[49]

4. Corporation sells assets to another corporation; both corporations part of 50-percent-or-more (or possibly more-than-20-percent) ownership chain (by vote or value)

T or T-SCo sells all of its assets to P or P-SCo; T or T-SCo already owns 51 percent of P's or P-SCo's voting stock or, in connection with the sale, T or T-SCo acquires 51 percent of P's or P-SCo's voting stock. The antichurning rules would apply in this situation since two corporations are treated as related to each other if one corporation owns (directly or through the application of the constructive ownership rules described in the next paragraph) 50 percent or more of the other corporation's stock, either by vote *or* by value.[50] For purposes of this test (unlike the related party tests described in 2.a. through c. above) nonvoting debt-like preferred stock is *not* taken into account.[51]

Under the constructive ownership rules that apply in this situation (and in the situations described in B.5., 6., and 7. below):

(a) a person is treated as owning a proportionate part of any stock owned indirectly through another corporation, partnership or trust

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[42]This rule differs from the rule discussed in III.B.4. through 7. below, where nonvoting debt-like preferred stock is disregarded in determining whether the parties are related.

[43]*See* section 267(c).

[44]For this purpose, family is defined to include spouse, siblings, ancestors, and descendants.

[45]Thus it is necessary to check all partnerships (including investment or tax shelter partnerships in which A is a limited partner) to see whether any of the other partners own P stock.

[46]If exercise of an option on already outstanding stock would cause A (and certain related parties) to own 50 percent or more of P's stock, however, A and P could be treated as related under the rule described in B.5. below.

[47]"T-SCo" means T is an S corporation. "P-SCo" means P is an S corporation. Unless otherwise stated, use of the term "T" or "P" means it is a C corporation.

[48]Sections 197(f)(9)(C)(i), 267(b)(11), and (12).

[49]Sections 197(f)(9)(C)(i) and 267(b)(10).

[50]Read literally, the antichurning rules described in B.4. through 7. apply only where T and P are more than 50 percent (rather than 50-percent-or-more) related. However, if T and P are 50-percent-or-more related, certain stock of P or T owned by other persons (e.g., certain stock owned by or for the benefit of employees) is treated as not outstanding, thereby causing T and P to be deemed to be more-than-50-percent related. Section 1563(c)(2); reg. section 1.414(c)-3(b) and (c) (applicable by virtue of reg. section 1.41-8(a)(3) and reg. section 1.52-1(g)). Thus, as a practical matter, the antichurning rules described in B.4. through 7. will typically apply where T and P are 50 percent or more related.

[51]Section 1563(c)(1); reg. section 1.52-1(g) (applicable by virtue of reg. section 1.41-8(a)(3)).

in which the first person owns, directly or indirectly, a 5 percent or greater interest,

(b) a person is treated as owning any already outstanding stock that it has an option to acquire (but should not be treated as owning any unissued stock which it has a right to acquire, e.g., through a warrant or conversion right), and

(c) an individual is treated as owning any stock owned by certain members of his family, not including siblings and including ancestors, adult children, and grandchildren only in limited circumstances.[52]

These constructive ownership rules differ from the rules applied in B.1. through 3. above, which are more stringent in some respects (i.e., the B.1. through 3. rules do not have a 5 percent *de minimis* limitation for constructive ownership through entities and define "family" more broadly) but are less stringent in other respects (i.e., the B.1. through 3. rules do not count indirect ownership through options).

As discussed below, there is some risk that a *more-than-20 percent* rather than a 50-percent-or-more test applies in determining whether two corporations are related under the rules of this paragraph 4.

The antichurning rules apply both to persons treated as related under section 267(b) and to persons treated either as members of the same "controlled group of corporations" or as "trades or businesses . . . under common control" under section 41(f)(1)(A) or (B). Although both sections 267(b) and 41(f) apply a 50-percent-related-party standard, section 197(f)(9) states that "in applying section 267(b) . . . '20 percent' shall be substituted for '50 percent'." No similar modification is made to the 50-percent-related-party standard of section 41(f).

The only provision of section 267(b) that treats two subchapter C corporations as related is section 267(b)(3). This subsection, however, does not itself specify a 50-percent-related-party standard (for which 20 percent could be substituted by section 197(f)(9)). Rather, section 267(b)(3) merely refers to the "controlled group" definition contained in section 267(f). (Section 267(f) in turn incorporates the rules of section 1563, substituting a 50-percent standard in place of an 80-percent standard.) While section 267(f) specifies a 50-percent-related-party standard, section 197(f)(9) does not direct that "20 percent" be substituted for "50 percent" in applying section 267(f). Thus, it appears that the 50-percent "controlled group" definition of section 267(f) is applied without modification for purposes of the section 197 antichurning rules. This conclusion is buttressed by at least three persuasive arguments based on legislative and regulatory language in section 197 and a prior antichurning rule, as reviewed in the following footnote.[53] Nevertheless, the law is not entirely clear on this point.

5. Same as 4. where either seller or buyer or both is a partnership or other unincorporated entity

The result is the same as described in B.4. above where either T or P or both are noncorporate entities. Since sections 267(b) and 267(f) do not apply to noncorporate entities, the risk that the rules described in B.4. might be applied by substituting more than 20 percent for 50 percent or more would not exist (although the more-than-20-percent related party rules described in B.3. above would apply).

6. Corporation sells assets to another corporation; 50-percent-or-more (or possibly more-than-20-percent) overlapping ownership by five or fewer individuals, trusts or estates

T or T-SCo sells all of its assets to P or P-SCo; individuals A and B each owns 30 percent of T's or T-SCo's stock (by vote or by value) and each also already

[52]Section 1563(e); reg. section 1.1563-3; reg. section 1.414(c)-4 (applicable by virtue of reg. section 1.41-8(a)(3) and reg. section 1.52-1(c)(1) and (d)(1)).

[53]First, the "controlled group" definition contained in section 267(f) is identical to the definition of a "controlled group of corporations" for purposes of section 41(f)(1)(A). (Section 41(f)(5), like section 267(f), incorporates the rules of section 1563, substituting a 50-percent standard in place of an 80-percent standard.) As noted above, section 197(f)(9) does not modify the 50-percent-related-party standard of section 41(f)(1)(A). It would be illogical as a matter of statutory construction to render the clear 50-percent-related-party standard of section 41(f)(1)(A) a nullity by extending section 197(f)(9)'s 20-percent modification of section 267(b) to section 267(f). This is particularly so because of the express reference of section 197(f)(9) to section 41(f)(1)(A) (rather than merely to section 41(f)(1)(B)).

Second, the section 197 antichurning rules are based on (and are somewhat narrower than) the antichurning rules enacted in 1981 in connection with the accelerated cost recovery system ("ACRS"). Like the section 197 antichurning rules, the ACRS antichurning rules (contained in former section 168(e)) applied to persons related under section 267(b) (with the 50-percent standard reduced, "in applying section 267(b)," to 10 percent) and to persons engaged in trades or businesses under common control within the meaning of section 52(a) or (b) (with the 50-percent-related-party standard, the same as that of section 41, not reduced). It is clear that most commonly controlled subchapter C corporations were not subject to the ACRS antichurning rules, because in 1981, section 267(b)(3) applied only where two corporations were more than 50-percent owned by a single individual and one of the corporations was a personal holding company or a foreign personal holding company. (Section 267(b)(3) was broadened, and section 267(f) enacted, in 1984.) Since it appears that the section 197 antichurning rules were not intended to have a significantly broader scope than the ACRS antichurning rules, applying the 50-percent-related-party standard of section 267(f) without modification appears to be correct.

Third, in regulations under the ACRS antichurning rules, the IRS interpreted the "substitution" of 10 percent for 50 percent "in applying section 267(b)" to mean a literal and narrow substitution, to be applied "by substituting '10 percent' for '50 percent' *within the provisions of section 267(b)*." Prop. reg. section 1.168-4(d)(6)(D) (emphasis added). There is no indication that regulations under section 197(f), when ultimately issued, should take any different position.

owns 26 percent of P's or P-SCo's stock (by vote or by value) or, in connection with the sale, A and B each acquires 26 percent of P's or P-SCo's stock (by vote or by value). This transaction would be subject to the antichurning rules since a corporation is treated as related to another corporation if the same five or fewer individuals, trusts or estates (directly or through the application of the constructive ownership rules described in B.4. above) own 50 percent or more[54] of both corporations (by vote or by value), taking into account only overlapping stock ownership.[55] For purposes of this test, nonvoting debt-like preferred stock is not taken into account.

As discussed in B.4. above, there is some risk that a more-than-20-percent rather than a 50-percent-or-more test applies for purposes of this section.

7. Same as 6. where either seller or buyer or both is a partnership or other unincorporated entity

The result is generally the same as described in B.6. above where either T or P or both are noncorporate entities. Since sections 267(b) and 267(f) do not apply to noncorporate entities, the risk that the rules described in B.4. and 6. might be applied by substituting more than 20 percent for 50 percent or more would not exist (although the more-than-20-percent-related-party rules described in B.3. above would apply).

C. Election to Avoid Antichurning Rule

As described in III.A. above, where the antichurning limitation applies, P is not permitted to claim any amortization deduction for goodwill or any other intangible which would not be amortizable without section 197.[56] However, in situations where the antichurning rules are triggered by a *relationship between buyer and seller exceeding 20 percent, but not exceeding 50 percent* (e.g., as described in B.1. through 3. above), seller may make a special election. If seller makes this election, (a) seller pays extra tax and (b) buyer is permitted to amortize under section 197 any basis step-up in the goodwill or goodwill-like intangibles resulting from the sale (but buyer is not permitted to amortize the portion of the purchase price for otherwise nonamortizable intangibles equal to seller's basis, if any, in such intangibles).[57]

In order to make this special election, seller must agree to pay immediate tax on the gain from the sale of the goodwill or otherwise nonamortizable intangible at the highest marginal federal income tax rate applicable to seller (i.e., 39.6 percent for an individual seller or 35 percent for a corporate seller). Thus, as a result of making the election, seller loses such benefits as (a) the ability to defer gain recognition on an installment sale, (b) the reduced tax rate for an individual seller on long-term capital gain (LTCG), (c) the reduced tax rates for an individual seller on taxable income below $250,000, (d) the reduced tax rates for a corporate seller on taxable income below $10 million, and (e) the ability to offset taxable income with a current year loss, an NOL, or a capital loss carryforward (or, in the case of a corporate seller, a loss carryback).

Therefore, whenever buyer and seller are more than 20 percent related and goodwill (or any other intangible which would not be amortizable without section 197) with a significant value is being acquired, the parties should:

(a) ascertain seller's basis (if any) in such intangible (since buyer can not claim amortization deductions to that extent),

(b) balance the tax benefits of 15-year amortization for the goodwill or similar intangible against the potentially onerous cost of the election to seller, and

(c) consider whether the parties might improve their overall position either by:

(i) reducing seller's (or related party's) equity interest in buyer to 20 percent or less or

(ii) restructuring such equity interest (e.g., by giving seller convertible debt rather than an immediate equity interest).

D. Partnership Transactions

In applying the section 197 rules to partnership transactions, three separate rules are potentially applicable. The practical impact — and interplay — of these rules appears not to have been given significant thought by the drafters. As a result, a literal application of the rules seems to produce results that are, at best, confusing and arbitrary.

The first rule applying to partnership transactions is entirely logical. It states that, in applying the antichurning rules, "*with respect to any increase in the basis of partnership property under sections 732, 734, or 743,* determinations . . . shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets."[58] As applied to sales of partnership interests, this rule applies the combination of "aggregate" (i.e., look-though) and "entity" concepts inherent in section 743. That is, to the extent of the increase in partnership basis which results from the transfer under section 743(b) (which increase is allocated to the transferee partner), the antichurning rules are applied by treating the transferor partner as selling a portion of the partnership's assets directly to the transferee partner. So long as the transferor and transferee are not related persons, the antichurning rules will not apply. On the other hand, to the extent the transferee merely obtains a share of the common basis of partnership property, the transfer does not change the depreciation or amortization method applicable to the partnership's assets.

The second rule applying to partnership transactions states that if a section 197 intangible is acquired

[54]*See* footnote 50.

[55]If individual A owns 30 percent of T's stock and 26 percent of P's stock, he is counted as only a 26 percent T shareholder, because his overlapping ownership is only 26 percent.

[56]Section 197(f)(9)(A).

[57]Section 197(f)(9)(B).

[58]Section 197(f)(9)(E).

in a transaction to which section 721 applies, the transferee is treated as the transferor for purposes of section 197 "with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor."[59] This second rule applies an "entity" concept to partnership contribution transactions, even though the general partnership rules — in particular section 704(c) — are more "aggregate" flavored.

The third rule applying to partnership transactions is the general antichurning rule. This rule will apply to a sale (apparently including a deemed sale under section 707(a)(2)(B)) of goodwill or a similar intangible by a person to a partnership if the partnership is treated as related to the seller under sections 267(b), 707(b)(1), or 41(f)(1).

As described in the following series of examples, these rules appear to produce surprisingly different results depending on the form in which a partnership transaction is structured.

Example (1): Corporation X and a subsidiary form a partnership, contributing tangible assets with an adjusted basis and FMV of $8 million and goodwill (a portion of which was purchased prior to the effective date of section 197 and a portion of which was self-generated) with an adjusted basis of $1 million and an FMV of $2 million. Corporation Y (which is unrelated to X) purchases from X a 40 percent interest in the partnership for $4 million.

Upon contribution of the assets by X and its subsidiary, the partnership takes a carryover basis of $1 million in the contributed goodwill, and the goodwill retains its status as a nonamortizable intangible. Upon Y's purchase of X's partnership interest for $4 million (which exceeds X's basis in the transferred interest by $0.4 million), the partnership (if it makes a section 754 election) increases its basis in the goodwill by $0.4 million, which increase is allocated to Y. Accordingly, Y has a 40-percent share of the $1 million common partnership basis in the goodwill and an additional $0.4 million basis in the goodwill under section 743(b).

On these facts, Y's 40-percent share of the $1 million common partnership basis in the goodwill is treated as a nonamortizable asset. Under the first rule for partnerships described above, however, Y's additional $0.4 million basis under section 743(b) is treated as amortizable over the 15-year period following Y's purchase of the partnership interest.

Example (2): Same facts as Example (1), except that X contributes the assets in exchange for a $4 million preferred interest and a 60-percent residual interest in the partnership and Y contributes cash of $4 million in exchange for a 40-percent residual interest in the partnership. The transaction is not treated as a disguised sale to which section 707(a)(2)(B) applies and the partnership does not use the deferred sale method described in prop. reg. section 1.704-3(d) to allocate income and deductions with respect to the contributed property.

On these facts, the partnership's basis in the contributed goodwill equals $1 million, the goodwill's adjusted basis in the hands of X. Accordingly, under the second rule for partnerships described above, no portion of the contributed goodwill is treated as an amortizable section 197 intangible, and neither X nor Y may be allocated amortization deductions with respect to the contributed goodwill.

Example (3): Same facts as Example (2), except that the partnership uses the deferred sale method described in Prop. Reg. section 1.704-3(d) to allocate income and deductions with respect to the contributed property. Under the deferred sale method, X's contribution of goodwill is treated as a sale of the goodwill to the partnership at FMV (with X recognizing gain on a deferred basis) and the partnership is treated as having a $2 million FMV basis in the contributed goodwill.[60]

The partnership's basis in the contributed goodwill equals $2 million, $1 million more than the adjusted basis in the goodwill in the hands of X. Accordingly, it appears that $1 million of the contributed goodwill (an amount equal to X's basis) would, under the second rule, retain the status it held in the hands of X as a nonamortizable, non-section-197 intangible.

To the extent of the $1 million basis step-up in the contributed goodwill, the partnership does not automatically step into the shoes of X. However, under the deferred sale method X is treated as selling the goodwill to the *partnership*. Because X owns a more than 20 percent interest in the partnership, X and the partnership are related persons under the antichurning rules, and hence it appears that the basis step-up in the goodwill would not be treated as an amortizable section 197 intangible unless X is eligible to, and does, make the gain recognition election described in 3 above. On these facts, X could not make a gain recognition election because X owns a more-than-

[59]Section 197(f)(2). This statutory rule expressly applies only to section 197 intangibles (and hence does not literally apply to transfers to a partnership of goodwill which is not a section 197 intangible, e.g., because it was self-generated or purchased by the transferor before the effective date of section 197). However, the legislative history appears to be broader, stating that "a transaction in which a taxpayer acquires an interest in an intangible held through a partnership (either before or after the transaction) will 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."

This rule also applies to partnership distributions under section 731 and to various nonpartnership nonrecognition transactions.

[60]Prop. reg. section 1.704-3(d)(1).

50-percent interest in the partnership. Accordingly, neither X nor Y may be allocated amortization deductions with respect to the contributed goodwill.

Example (4): Same facts as Example (2), except that, at the time of X's contribution, the partnership enters into a binding agreement to redeem X's preferred partnership interest in exchange for the $4 million of cash contributed by Y. Under the disguised sale rules of section 707(a)(2)(B) and reg. section 1.707-3, X is treated as contributing 60 percent of the assets to the partnership and selling 40 percent of the assets to the partnership.

In this example, the partnership's basis in the goodwill equals $1.4 million ($0.6 million carryover basis on the portion deemed contributed and $0.8 million FMV basis on the portion deemed sold), $0.4 million more than the adjusted basis of the goodwill in the hands of X. The portion of the goodwill deemed contributed and which has a carryover basis in the hands of the partnership would, under the second rule, not be treated as an amortizable section 197 intangible.

The portion of the goodwill deemed sold under section 707(a)(2)(B) is deemed sold to the partnership. Because X owns a more-than-20-percent interest in the partnership, X and the partnership are related persons under the antichurning rules, and hence it appears that the basis step-up in the goodwill would *not* be treated as an amortizable section 197 intangible unless X is eligible to, and does, make the gain recognition election described in 3 above. On these facts, X could not make a gain recognition election because X owns a more-than-50-percent interest in the partnership. Accordingly, neither X nor Y may be allocated amortization deductions with respect to the contributed goodwill.

Example (5): Same facts as Example (4), except that prior to the formation of the partnership X sells 40 percent of the assets to Y for $4 million; X then contributes the retained 60 percent of the assets for a 60-percent interest in the partnership and Y contributes the purchased 40 percent of the assets for a 40-percent interest in the partnership. Y takes an FMV basis of $0.8 million in the 40 percent of the goodwill purchased from X. Because X and Y are not related, the antichurning rules should not apply to Y's purchase of the goodwill and hence the goodwill should be an amortizable section 197 intangible in the hands of Y.

Following the contribution of the assets to the partnership, the partnership's basis in the contributed goodwill equals $1.4 million ($0.6 carryover basis in the goodwill contributed by X plus $0.8 million carryover basis in the goodwill contributed by Y). Under the second rule, no portion of the goodwill contributed by X would be treated as an amortizable section 197 intangible.

The treatment of the goodwill contributed by Y, however, is unclear. Under the second rule (i.e., the partnership steps in to the shoes of the contributing partner), the goodwill contributed by Y should qualify as an amortizable section 197 intangible.[61] However, under the general antichurning rules, it appears that the goodwill contributed by Y would not qualify as an amortizable section 197 intangible, because the goodwill was held by X, a person related to the partnership, before the date of enactment of section 197. It appears that the IRS is likely to interpret the antichurning rule as overriding the second rule in this situation.[62]

IV. Impact on Transactions and Planning

A. Target Has Substantial Goodwill

Where P will allocate a significant part of the purchase price to goodwill or goodwill-like intangibles, structuring the acquisition for an SUB becomes relatively more attractive under section 197 than under prior law (assuming the antichurning rules described in III above do not apply). Hence, certain acquisitions that, from a tax standpoint, would have been better structured for COB under prior law (i.e., as a stock acquisition with no section 338 election) might produce a better net after-tax result for the parties under section 197 if structured for SUB (i.e., as a taxable asset purchase *or* as a taxable forward merger *or* as a section 338 stock acquisition). However, even after section 197's enactment it will still normally be advantageous to structure acquisitions as a stock purchase with no section 338 election, unless T *either:*

(a) is an S corporation, *or*

(b) is a subsidiary member of a consolidated group, *or*

(c) has a substantial NOL.

B. Allocating to Goodwill Versus to a Noncompete

Under prior law, in an SUB acquisition, the parties often specifically allocated consideration to a noncompete agreement where purchase price would otherwise be allocable to nondeductible goodwill. Assuming the amount so allocated did not exceed the value of the noncompete agreement and did not represent additional consideration for the other assets acquired, the noncompete payment was amortizable over the legal life of the noncompete agreement (e.g., three to five years).

Because section 197 amortizes both purchased goodwill and a noncompete over 15 years, from a tax standpoint buyer no longer benefits from allocating purchase price to a noncompete rather than to goodwill in an SUB acquisition (unless the antichurning limitation on goodwill amortization applies as discussed in III above). Moreover, depending on the circumstances,

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[61]In this case, it would be fair and logical to permit the partnership to allocate all of the amortization deductions attributable to the goodwill contributed by Y to Y, and for X to bear the entire tax detriment of the absence of amortization deductions on the goodwill contributed by X. It is not at all clear, however, that such an allocation would be permissible under section 704(b) and (c) and the regulations thereunder.

[62]*Cf.*, prop. reg. section 1.168-4(e), Example (8) (ACRS antichurning rule applies to similar situation).

there are two potential benefits to allocating purchase price to goodwill rather than to a noncompete:

First, seller's gain on the sale of goodwill generally is taxable as LTCG, whereas a noncompete payment is taxed as ordinary income ("OI"). Given the difference between the new highest marginal OI rate (39.6 percent) and the LTCG rate (28 percent) *for individuals,* the tax savings can be significant where seller is an S corporation, a partnership of individuals, or a sole proprietor. However, where seller is a C corporation, it may still prefer a noncompete payment to its shareholders (although taxed to the shareholders as OI) rather than a goodwill payment to the corporate seller, because the noncompete payment would be taxed only at the shareholder level and thus avoid corporate-level tax.

Because a C corporation is taxed at the same rate on LTCG and OI, a C corporation receiving a noncompete payment often will be indifferent to this issue, unless it has an available capital loss which can only be used against CG.

Second, for GAAP purposes, buyer can amortize goodwill over a period of up to 40 years, whereas a noncompete payment is amortized for GAAP purposes over the life of the noncompete agreement. Therefore, goodwill has a less adverse impact on GAAP earnings in the early years, and hence, is a more attractive GAAP asset than a short-lived noncompete agreement. The favorable GAAP earnings result produced by goodwill is particularly important for a publicly traded buyer (or a buyer which anticipates an IPO).

The choice of allocating purchase price between a noncompete agreement and goodwill is not available in a stock purchase with no section 338 election, because there is no SUB for goodwill or any purchased asset (other than a noncompete purchased from T's shareholders). Hence, a stock purchase with no section 338 election, allocating purchase price to a noncompete agreement often will continue to provide a net tax benefit to the parties, although that benefit will be smaller under the 1993 act in light of:

(a) the higher OI tax rates imposed on an individual recipient of a noncompete payment and

(b) buyer's longer (15-year) amortization period for noncompete payments.

V. Section 197 Effective Dates and Elections

Section 197 contains three important effective date rules:

A. Acquisition after August 10, 1993

Section 197 applies to every acquisition closing after August 10, 1993, unless there was a binding contract in effect on August 10, 1993, and the taxpayer elects out of section 197 (as described in 3 below). In contrast, no acquisition that closed before August 11, 1993, is subject to section 197, unless the taxpayer (or a related person) makes a retroactive election into section 197 (as described in B below).[63]

[63]1993 act section 13261(g)(2).

B. Election Back to July 25, 1991

A taxpayer can elect to apply section 197 to any acquisition that *closed after July 25, 1991,* i.e., within approximately 25 months before section 197's enactment.[64] However, such an election is binding on *all* acquisitions made after July 25, 1991, (a) by the taxpayer and (b) by each corporation, partnership or other entity under "common control" with the electing taxpayer at any time after August 2, 1993, and on or before the date the election is made.[65] According to the 1993 Conference Report (at 691), it is expected that the election will be required to be made on the taxpayer's federal income tax return for the taxable year that includes August 10, 1993.

For purposes of the retroactive election rules, "common control" means a 50-percent-or-more[66] (by vote or by value) relationship, either as part of a chain of 50-percent-or-more related entities or as part of a brother-sister group of entities 50-percent-or-more owned by five or fewer individuals, trusts or estates. The 50-percent-or-more determination is made by ignoring nonvoting debt-like preferred stock and using the constructive ownership rules described in III.B.4. above.

For example, if a large corporation (Bigco) owns 50 percent or more of the stock (by vote or by value) of each of 10 affiliated companies, and if one of the affiliated companies (perhaps without the consent, or even the knowledge, of Bigco) elects to apply section 197 retroactively, section 197 would apply automatically to:

(a) the electing company,

(b) Bigco,

(c) Bigco's nine other 50-percent-or-more owned affiliated companies, and

(d) any other entities 50-percent-or-more related to the electing company.

Similarly, if an investment partnership owns 50 percent or more of the stock (by vote or by value) of each of 10 portfolio companies, and if one of the portfolio companies (perhaps without the consent, or even the knowledge, of the investment partnership) elects to apply section 197 retroactively, it appears that section 197 would apply automatically to:

(a) the electing portfolio company, and

[64]1993 act section 13261(g)(2)(A).

[65]1993 act section 13261(g)(2)(B)(ii).

[66]*See* footnote 50.

(b) investment partnership's nine other 50-percent-or-more owned portfolio companies.[67]

Given the potentially global implications of this election where 50-percent-or-more relationships are involved — sweeping in all post-July 25, 1991, acquisitions made by the electing taxpayer and all 50-percent-or-more related persons — this election should be made only after careful analysis of its consequences both to the electing person and to all related entities. Moreover, if it is determined that a retroactive election would be disadvantageous, affirmative action should be taken to prevent (either by the exercise of shareholder control or by contractual agreements) any related entity from making a retroactive election.[68]

The desirability of electing to apply section 197 retroactively for a particular post-July 25, 1991, and pre-August 11, 1993, acquisition will depend on the particular mix and useful lives of the intangible assets acquired. Often the election will be desirable for taxable SUB acquisitions involving a substantial amount of otherwise nonamortizable goodwill. In contrast, the election generally should be avoided for acquisitions involving intangibles that, under prior law, would be amortizable over lives shorter than 15 years. For example, the application of section 197 would adversely affect the amortization of a three-year covenant not to compete or a seven-year customer list, because it would extend the amortization of such otherwise short-lived assets to 15 years.

C. Election: Binding Contract on August 10, 1993

A taxpayer can elect to exclude from section 197 any acquisition that closed after August 10, 1993, so long as it was subject to a binding written contract in effect on that date and at all times thereafter until the closing.[69] This election may not be made if the taxpayer or any 50-percent-or-more related party made the election discussed in B. immediately above to apply section 197 retroactively.[70] Surprisingly, there are no other aggregation and common control rules for this election. Hence, it appears that if buyer made two acquisitions that were subject to binding contracts on August 10, 1993, and closed after August 10, 1993, buyer may elect to exclude one from section 197 but leave the other covered by section 197.

Under what circumstances will a letter of intent or definitive agreement signed on or before August 10, 1993, qualify as a "binding contract" for section 197? For a letter of intent to qualify, it must constitute a legal obligation of buyer under state law. Moreover, an otherwise binding letter of intent or an otherwise binding definitive agreement is not disqualified because it contains reasonable commercial conditions *not under buyer's control.* For example, a material adverse change clause, a Hart-Scott-Rodino clause, or an FCC-approval clause will not disqualify an otherwise binding written agreement. There is risk the IRS might argue that a due diligence or financing out disqualifies an agreement because it is too much in buyer's control. A court may reject such an IRS challenge so long as applicable state law imposes some restrictions (e.g., an obligation to act reasonably) on buyer's ability to invoke the due diligence or financing out and refuse to close.[71]

VI. Settlement of Pending Cases

Section 197 was enacted to eliminate the frequent disputes between buyers and the IRS regarding (a) whether particular intangibles were nonamortizable as a matter of law, (b) whether the taxpayer could, based on the facts of the particular case, establish a reasonably ascertainable useful life for the intangible, and (c) the proper allocation of the purchase price among the assets acquired. Section 197 does not directly affect disputes arising under prior law (except to the extent buyer makes a retroactive election to apply section 197 to all post-July 25, 1991, acquisitions). However, the legislative history of the 1993 act forcefully instructs

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[67]As a result of a quirk in the "common control" rules, it appears that the investment partnership itself — so long as it is a noncorporate entity engaged in a mere investment activity rather than a "trade or business" — is not treated as a member of the commonly controlled group. *See* 1993 act section 13261(g)(2)(B)(ii); section 41(f)(1)(B)(i); Treas. reg. section 1.41-8(a)(2) (covering unincorporated businesses only if engaged in a trade or business within the meaning of section 162).

Moreover, based on this quirk, it may be possible to argue (although there is a strong risk that the IRS and the courts may reject this argument) that a retroactive section 197 election by one of investment partnership's portfolio companies does not cause section 197 to apply retroactively to the partnership's nine other 50-percent-or-more portfolio companies. *See* Treas. reg. sections 1.41-8(a)(2); 1.52-1(c)-(e). This argument generally would not be available, however, if five or fewer individuals, trusts or estates owned directly or indirectly (e.g., through the investment partnership) 50 percent or more of the stock (by vote or by value) of the portfolio companies. *See* sections 41(f)(1)(A), 41(f)(5), and 1563(a)(2).

[68]This rule, if strictly applied, produces absurd (and frightening) results. For example, assume a multinational corporation with many affiliates owns 50 percent or more of the equity value, but no voting stock, of a small portfolio company. An election by the small portfolio company would trigger the application of section 197 for the multinational corporation and all of its affiliates, even though the multinational corporation has no control over the electing company.

It would be nice (but is perhaps overly optimistic to hope) for Congress promptly to correct this misguided rule.

A more rational rule would require all affiliates affected by the election to consent to the election. *Cf.* section 341(f)(6) (affirmative consent required by all corporations affected by section 341(f); section 1362(a)(2) and (e)(3)(B) (all affected S corporation shareholders must consent to S election and to election to use closing-of-books method to allocate income in S termination year). However, even this approach would have its troublesome aspects: it would allow a small partially owned subsidiary to block a retroactive section 197 election by the multinational corporation which owns at least 50 percent by value (perhaps less by vote) of the recalcitrant small subsidiary.

[69]1993 act section 13261(g)(3)(A).

[70]1993 act section 13261(g)(3)(A)(ii).

[71]*Cf. Barto v. United States,* 823 F. Sup. 1360 (E.D. Mich. 1993) (applying state Uniform Commercial Code law to determine whether a written sale contract was binding on the parties).

the IRS to resolve disputes arising out of pre-section 197 acquisitions on an expedited basis:

> The conferees urge the Internal Revenue Service in the strongest possible terms to expedite the settlement of cases under present law. In considering settlements and establishing procedures for handling existing controversies in an expedited and balanced manner, the conferees strongly encourage the Internal Revenue Service to take into account the principles of [section 197] so as to produce consistent results for similarly situated taxpayers. However, no inference is intended that any deduction should be allowed in these cases for assets that are not amortizable under [pre-section 197] law.

As a further spur to settlement of pending cases, the Conference Report directs the Treasury to report annually to Congress regarding the volume of pending disputes in audit and litigation and the IRS's progress in resolving the disputes.