REPORT #762

TAX SECTION

New York State Bar Association

Letter on Effect of Newark

Table of Contents

Cover Letter: i

1. The Effect of Newark. ii

2. Effect of the Proposed Legislation. iv

3. Should the Proposed Legislation Apply Retroactively? vii

TAX SECTION

New York State Bar Association

June 2, 1993

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Re: Effect of the Supreme Court decision in Newark Morning Ledger Co. v. U.S. on proposed legislation on amortization of intangibles[1]

Dear Mr. Chairman:

In November, 1991, we submitted a report on proposed legislation on amortization of intangibles, under which most intagible

[1] This letter was prepared by an Ad Hoc Committee on Amortization of Intangibles of the Tax Section, composed of the following members: Richard G. Cohen (Chair); Reuven Avi-Yonah; William L. Burke; Dale S. Collinson; Arthur A. Feder; Melissa Goldman; Kenneth Gross; Richard Hiegel; Michael Hirschfeld; Larry Kahn; George Middleton; Steve Miller; Ronald A. Pearlman; Yaron Z. Reich; Irving Salem; Michael L. Schler; Sterling L. Weaver; and George E. Zeitlin. The letter was principally drafted by Reuven Avi-Yonah. In addition to committee members, helpful comments were received from Peter C. Canellos, Robert A. Jacobs, Richard L. Reinhold, Michelle P. Scott and David E. Watts.

under which most intangible assets acquired after enactment, including goodwill and going concern value, would be amortized ratably over a 14-year life.[2] Similar legislation (the "Proposed Legislation") has been introduced in the current session of Congress and passed by the House of Representatives.[3]

This letter addresses the effect on the Proposed Legislation of the recent Supreme Court decision in Newark Morning Ledger Co. v. United States.[4] In our view, the Supreme Court decision confirms and strengthens the reasons we expressed in the 1991 Report supporting the approach taken in the Proposed Legislation.

The decision eliminated the one simple, albeit harsh, solution to the problem of the complexity of current law -- i.e., preclusion of amortization as a matter of law under a broad definition of goodwill. It leaves the entire area to be dealt with on a case-by-case, factual basis, which involves substantial legal and compliance costs. We therefore recommend that in the interest of fairness and simplification of the tax law, the Proposed Legislation should be enacted as promptly as possible.

1. The Effect of Newark.

In the 1991 Report, we surveyed the case law on amortization of intangibles, and concluded that

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[2] New York State Bar Association Tax Section, Report on Proposed Legislation on Amortization of Intangibles (1991), reprinted in Tax Notes (November 25, 1991), 943 (the "1991 Report").

[3] H.R. 13, 103rd Cong., 1st Sess. (1993), included in H.R. 2264, the Omnibus Budget Reconciliation Act of 1993, as approved by the Ways and Means Committee on May 13, 1993 and passed by the House on May 27, 1993. Similar legislation was passed by Congress as part of H.R. 4210 (vetoed by President Bush on March 20, 1992) and H.R. 11 (vetoed by President Bush on November 5, 1992).

[4] Newark Morning Ledger Co. v. United States, 61 U.S.L.W. 4313 (April 20, 1993) ("Newark").

> the present law on amortization of intangibles foments disputes between taxpayers and the IRS. ... Thus, there is a substantial potential for continuing controversy. Controversies are expensive for both taxpayers and the government and outcomes uncertain.[5]

The General Accounting Office reported that in 1989 the IRS had proposed $8 billion in adjustments in open cases relating to amortization of intangibles, over half of which related to customer and market-based intangibles.[6]

The majority of those disputes challenged an IRS determination that intangibles identified by taxpayers upon acquisition of a business were by their nature indistinguishable from the goodwill or going concern value of the business and therefore could not be amortized as a matter of law. In Newark, which involved the purchase of a newspaper business and the taxpayer's allocation of a portion of the purchase price to a subscriber base, the Third Circuit accepted this IRS position.[7] The Supreme Court has now reversed, holding that a taxpayer's ability to amortize an intangible asset depends not on the nature of the asset or the context in which it was acquired, but on whether the taxpayer can prove that the asset has an ascertainable value and limited useful life.[8]

The Supreme Court decision in Newark has not resolved all controversies in this area. While taxpayers will be encouraged by the decision to identify, value and determine useful lives for amortizable intangibles, taxpayers still bear the burden of proving

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5 1991 Report at 948.

6 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-991-88) 24, 29 (Aug. 19, 1991).

7 Newark Morning Ledger Co. v. United States, 945 F.2d 555 (3rd Cir. 1991).

8 Newark, at 19. Thus, the Court held that any asset that has a limited useful life and an ascertainable value is by definition not goodwill, and goodwill is the residual value left after all other assets that meet the above definition have been accounted for. Id., at 18-19 n.13.

that the intangible at issue has an ascertainable value and a limited useful life.[9] Thus, the Newark decision, while ensuring that the IRS cannot deny taxpayers amortization as a matter of law, encourages taxpayers to seek to establish values and useful lives for a wide variety of intangible assets, while the IRS can continue to contest those values and lives.[10] In the absence of definitive legislation, the likely result is a continuation and escalation of the audit and litigation quagmire described in the GAO report and in the 1991 Report. We therefore reiterate and reinforce our strong support for the approach taken by the Proposed Legislation and recommend that it be enacted as promptly as possible.

2. Effect of the Proposed Legislation.

Some opponents of the Proposed Legislation fear that it will encourage acquisitions (and more particularly, hostile takeovers), because the buyer will be entitled to amortize the target's goodwill and going concern value.[11] Especially after the Newark decision, we believe that the Proposed Legislation, when compared to current law, will not encourage (and may discourage) acquisition activities.

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[9] The Newark opinion has left unclear the status of other types of intangibles that more closely resemble going concern value than goodwill, such as work-force in place. The Court in dicta expressed its approval of Ithaca Industries v. Commissioner, 97 T.C. 253 (1991), in which the Tax Court held that work-force in place is not amortizable where new workers are expected to replace retiring workers, so that there is no attrition in the work-force as such. However, the continuing scope of this manifestation of the "mass asset" rule is difficult to define, and continued controversy between taxpayers and the IRS is therefore to be expected on both the legal and factual aspects of this and similar cases.

[10] The potential existence of intangibles not previously recognized under case law can also be a weapon in the hands of the IRS. See, e.g., TAM 9317001 (January 12, 1993) (rejecting the IRS agent's attempt to identify as separate intangibles the "neighborhood effect" and "protected status" of acquired satellite transponders).

[11] See, e.g., Washington Post, Business Section F-3 (April 21, 1993) (reporting opposition by the House Members in the Conservative Democratic Forum and by the United Food and Commercial Workers International Union).

We have three reasons for this conclusion. First, we believe the Proposed Legislation would have no effect at all on hostile acquisitions. Such acquisitions are always stock acquisitions as opposed to asset acquisitions. Following repeal of the General Utilities doctrine in 1986, a purchaser of stock cannot obtain a stepped-up asset basis in a target's assets (including intangible assets) without subjecting the target to tax on the appreciation on those assets.[12] Since the detriment of the up-front tax on the entire appreciation is always greater than the benefit of the resulting amortization or depreciation deductions (no matter how rapid they may be), a purchaser of stock in a hostile acquisition would never have the opportunity to take advantage of the Proposed Legislation.

Second, as to friendly asset acquisitions,[13] we believe that the Proposed Legislation will not generally increase the attractiveness of such acquisitions to buyers (or, therefore, the price that buyers would generally be willing to pay), and may in fact decrease their attractiveness. To be sure, the Newark decision itself could arguably be viewed as creating an incentive for acquisition activity, limited only by the expense of future litigation if the issue should be challenged by the IRS (an expense which buyers have generally been willing to incur). However, given that Newark is the law, a buyer today may well be able to amortize

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[12] Newark involved an acquisition before 1986, in which the buyer was able to liquidate the target and obtain a stepped-up basis in its assets under former I.R.C. section 334(b)(2) without the target paying tax.

[13] We include in this category acquisitions of subsidiary stock treated as asset acquisitions under section 338(h)(10) of the Internal Revenue Code. Asset acquisitions, or section 338(h)(10) stock acquisitions, still occur in two situations: (1) when buying a division, where the seller has no choice but to pay the tax on the asset sale (or the gain is offset by net operating losses); and (2) when buying a subsidiary, where the seller's basis in the subsidiary stock is the same as the subsidiary's basis in its assets and the seller is therefore indifferent (except perhaps as to character of gain) between selling stock or assets.

many purchased intangible assets over a shorter period than the 14 years provided under the Proposed Legislation.[14]

As a result, amortization deductions under current law, even though not permitted with respect to goodwill, may well have a value in excess of the deductions allowed by the Proposed Legislation. In addition, the benefits of current law over the Proposed Legislation may be particularly great in the most important early years following the acquisition. As a result, the Proposed Legislation might actually discourage takeover activity. It should be noted that this conclusion is consistent with the fact that the Proposed Legislation is now expected to be a revenue raiser.

Finally, even in those cases where buyers of assets would benefit from the Proposed Legislation, we believe the impact of the Proposed Legislation on acquisition activity is likely to be quite limited. As noted above, the buyer can only obtain the benefit of amortization deductions if the seller pays an up-front tax on the appreciation in the sold assets. This tax is generally very significant; even where the seller had recently acquired the assets and therefore has a relatively high tax basis, the seller would frequently have amortized some assets rapidly and therefore have to pay a tax on the sale.[15]

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[14] The Proposed Legislation also has provisions that impede taxpayers' ability to structure transactions designed to obtain faster amortization than the uniform 14 year period for some intangible assets acquired as part of a business. No such impediments exist under current law, under which taxpayers can sell and write off the remaining basis of intangibles with a long useful life, while retaining assets with a short useful life, thus significantly reducing the average amortization period of the entire acquired business.

[15] For example, if a seller had bought a division (including amortizable intangible assets and goodwill) for 100 in 1990, amortized the assets (other than the goodwill) to 75, and sells them for 100 in 1994 after the Proposed Legislation has been enacted, the taxpayer would have to pay tax on the 25 of gain for the buyer to be able to amortize the goodwill. The only cases where there would be no seller gain are where the division had declined in value to 75 (in which case the goodwill would probably also have evaporated, and the buyer could not amortize it) or when all of the division's assets are not amortizable (an unlikely scenario after Newark).

As a result, even if buyers would be willing to pay increased amounts for assets in light of the Proposed Legislation, we believe the prospect of such higher prices would be unlikely to increase the level of acquisition activity. The immediate up-front tax cost of a sale is likely to be very large, and the increase in price payable by a buyer (based on the benefits of the Proposed Legislation as compared to current law) is likely to be relatively small. As a result, we do not believe the Proposed Legislation would cause any significant number of new acquisitions to occur.

3. Should the Proposed Legislation Apply Retroactively?

In our 1991 Report, we considered retroactivity in ligh0t of the stated objective of reducing controversies, but agreed with the prospective approach taken in the original legislation (and followed in the Proposed Legislation, as currently drafted) because

> retroactive changes would defeat the legitimate, bargained-for expectations of some taxpayers and shower others with unexpected and unbargained-for windfalls.[16]

We continue to believe that mandatory retroactivity is not advisable, especially since the current law has been clarified by Newark, and therefore there is one less issue to be resolved by the Proposed Legislation. Allowing taxpayers to elect retroactive application would inappropriately reward those taxpayers who took the most aggressive positions on their returns, and therefore have the greatest chance of losing in court, by allowing them to elect retroactive application of the Proposed Legislation. By contrast, more conservative taxpayers who did not take amortization deductions for intangibles of marginal validity would receive

[16] 1991 Report at 960.

little or no benefit from a retroactive election.[17]

We support the provision of the Proposed Legislation which permits taxpayers to elect retroactive, application of the Bill to assets acquired after July 25# 19S1 (the date intangible amortization legislation was first introduced and the date to which a 1991 House Resolution refers).[18] We believe that in view of the judicial and legislative background of this issue, the retroactivity provided in the Proposed Legislation would be a reasonable accommodation.

In our 1991 Report, we recommended that relevant Committee Reports encourage the IRS and taxpayers to settle existing controversies where the law is unclear by applying the uniform amortization approach of the Proposed Legislation.[19] We continue to believe that the legislative history of the Proposed Legislation should encourage the IRS to settle outstanding cases on a basis consistent with the principles of the Proposed Legislation in those cases in which the IRS considers such a settlement to be appropriate. The legislative history should also indicate that in

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[17] We therefore recommend that Congress not enact provisions similar to the Senate Finance Committee version of H.R. 11, that would have permitted taxpayers to amortize 75% (later reduced to 50%) of all amortizable intangibles identified in their returns for all open years.

[18] H. Res. 292, 102nd Cong., 1st Sess., 137 Cong. Rec. H. 11317 (November 26, 1991).

The resolution read:

> RESOLVED, That it is the sense of the House of Representatives that any legislation enacted with respect to amortization of goodwill and certain other intangibles for Federal income tax purposes should contain a provision permitting taxpayers to elect in a consistent manner the provisions of such legislation with respect to transactions after the date on which H.R. 3035 of the One Hundred Second Congress was introduced [July 25, 1991] and before the otherwise prescribed effective date of such legislation.

[19] This approach was adopted in the Conference Committee report on H.R. 11 and in the Ways and Means Committee report on H.R. 2141. H. Rept. 102-1032, 102nd Cong., 2nd Sess., 337-338 (October 6, 1992); W.M. Rept. 103-11, 103rd Cong., 1st Sess., 340 (May 19, 1993).

instances where the law is not clear, the IRS might appropriately settle cases on the basis of applying a uniform amortization period to all acquired amortizable intangibles.[20] Such an approach in the context of Newark should encourage settlement of many of the current controversies between the taxpayers and the IRS.

* * *

In summary, we strongly endorse the approach taken by the Proposed Legislation. Moreover, in view of the fact that taxpayers may have reasonably expected to amortize intangibles acquired after July 25, 1991, and are now forced by mandatory deadlines to file returns for periods after that date without being able to apply the uniform amortization approach, we urge Congress to pass the Proposed Legislation as promptly as possible.

Respectfully submitted,

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Chair

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[20] In addition, the legislative history could also indicate that the IRS could adopt uniform national amortization guidelines for certain types of intangibles. While we recognize that this endeavor may prove difficult, given the variation even within one industry, in other contexts the IRS and taxpayers have found such guidelines helpful in settling disputes. See, e.g., Rev. Proc. 69-21, 1969-2 C.B. 303 (five year amortization guideline for software development costs); and cf. the recent report that the IRS has developed national guidelines for settling small pension plan actuarial cases, BNA Daily Tax Report (May 6, 1993).

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