United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

144950

For Release on Delivery Expected at 10:00 a.m. EDT Wednesday October 2, 1991

TAX POLICY

Amortizing Purchased Intangible Assets

Statement of
Jennie S. Stathis, Director,
Tax Policy and Administration Issues,
General Government Division

GAO/T-GGD-92-01

<u>AMORTIZING PURCHASED INTANGIBLE ASSETS</u>

SUMMARY OF STATEMENT BY
JENNIE S. STATHIS
DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

The tax treatment of intangible assets is one of the oldest controversies between taxpayers and the Internal Revenue Service (IRS). GAO's concerns with the current tax rules for the treatment of purchased intangible assets involve complexity and fairness issues. The rules are complex in application because they lack adequate standards for determining which purchased intangible assets can be amortized for tax purposes. In turn, this lack of clear guidance has resulted in different treatment of similarly situated taxpayers, improper measurement of taxable income for some taxpayers, and protracted conflicts between IRS and taxpayers.

GAO has recently issued a report on this subject, <u>Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets</u> (GAO/GGD-91-88, Aug. 9, 1991), which states that 70 percent of the unresolved purchased intangible asset issues in open audit cases as of mid-1989 involved disputes over whether taxpayers had purchased nonamortizable goodwill or some intangible asset eligible for amortization. The remaining 30 percent involved disputes over useful life and/or value determinations. The issues covered taxpayers in nine industries who had claimed amortization deductions for 175 types of purchased intangible assets valued at $23.5 billion. GAO concluded that an amortization scheme patterned after the current rules for tangible asset depreciation would improve tax administration and income measurement. Therefore, GAO recommended that Congress amend current law to allow amortization of all purchased intangible assets, including goodwill, over specific statutory cost recovery periods.

The legislation introduced by Chairman Rostenkowski, H.R. 3035, would help solve the administration and fairness problems that GAO identified in its report. However, the one recovery period applied to the purchase of an individual intangible asset, apart from the acquisition of a business, will give rise to questions as to whether the recovery period matches the useful life of the asset.

Mr. Chairman and Members of the Committee:

It is a pleasure to be here today to assist the Committee in its deliberations on the tax treatment of intangible assets. The issue is one of the oldest controversies between taxpayers and the Internal Revenue Service. The opportunities for disputes in this area greatly increased during the 1980s when business acquisitions increased and led to a growth in reported values of intangible assets from about $45 billion in 1980 to $262 billion in 1987.

We recently completed a review of this area for the Joint Committee on Taxation and my statement is based on that review and the subsequent report, Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets (GAO/GGD-91-88), issued on August 9, 1991. Our concerns with the current tax rules for the treatment of purchased intangible assets involve questions of both complexity and fairness. The rules are complex in application because they provide inadequate standards to taxpayers and the IRS for determining which purchased intangibles may be amortized. In turn, the lack of clear guidance has resulted in different treatment of similarly-situated taxpayers and, for some taxpayers, improper measurement of taxable income.

We reviewed IRS information on 2,166 unresolved purchased intangible asset issues in IRS' inventory of open audit cases as of mid-1989. The information covered taxpayers in nine industries who had claimed amortization deductions for 175 types of purchased intangible assets valued at $23.5 billion. The vast majority--70 percent--of these issues involved a dispute over whether the taxpayer had purchased nonamortizable goodwill or an intangible asset eligible for amortization. Taxpayers identified numerous intangible assets as separate from goodwill and claimed tax deductions based on their own calculations of the assets' values and useful lives. The IRS denied these deductions, claiming that the assets were not amortizable because they were goodwill or the functional equivalent of goodwill. Because the current law contains no definition of goodwill, many such controversies end up in the courts, which provide fact-specific and sometimes contradictory opinions.

Taxpayers and the IRS also clash over the appropriate useful lives and values to assign to purchased intangible assets. Because no rules exist for determining amortization periods for most intangible assets, taxpayers must determine separately the useful life of each individual asset. Taxpayers' determinations are frequently challenged by the IRS, and both parties use complex studies to determine the useful life and value that should apply to a particular intangible asset.

As we reported, conflicts between taxpayers and the IRS are likely to continue unless amortization rules for intangibles are clarified. The current rules are based on long-standing regulations and sometimes conflicting definitions formulated by courts in their attempts to apply the regulations to specific controversies. The rules require taxpayers to identify each intangible asset purchased, determine whether or not it is goodwill or its functional equivalent, and, if it is not, determine its value and how long it will be useful to the business. In contrast, the depreciation of tangible assets is based on specific statutory periods designed to simplify calculation of deductions and eliminate controversy.

Our report concluded that an amortization scheme patterned on the current rules for tangible assets would improve administration and income measurement. Consequently, we recommended that Congress amend current law to allow amortization of all purchased intangibles, including goodwill, over specific statutory cost recovery periods. Eliminating any distinction between the tax treatment of purchased goodwill and that of other purchased intangibles would do away with controversies over whether the taxpayer has purchased an amortizable asset. Financial accounting requires the amortization of goodwill while tax accounting does not allow it. Financial accounting requires such write-offs because goodwill is generally recognized as a wasting asset. Allowing tax deductions for the cost of all wasting intangible assets consumed by a business would improve the measurement of income and treat all forms of investment more equitably.

Establishing statutory cost recovery periods would simplify useful life determinations. While we made no recommendations concerning numbers or composition of categories or the length of recovery periods, we noted that the more categories you have, and the greater the span of cost recovery periods, the more conflicts you are likely to have.

Differing legislative solutions have been proposed to determine which purchased intangible assets are amortizable. Legislation recently introduced by the Chairman, H.R. 3035, requires the amortization of most purchased intangible assets, including goodwill, over 14 years. Thus, the bill would help solve the problems with administration and fairness that we identified in the course of our study. The one recovery period for intangible assets purchased as part of the acquisition of an entire business would provide certain tax treatment which could be factored into the purchase price. The one recovery period would also eliminate controversies that might arise over the appropriate category for a particular asset were there to be multiple recovery periods. Additionally, use of one period could improve the accuracy of the calculation of taxable income to the extent that the period approximates the actual average useful life of all intangible assets acquired with the business.

However, the one recovery period applied to the purchase of an individual intangible asset, apart from the acquisition of a business, will give rise to questions as to whether the recovery period matches the useful life of the asset. For example, assets related to information technology may become quickly obsolete and thereby have shorter useful lives. Conversely, contractual agreements may be set for terms which exceed the stipulated recovery period.

H.R. 3035 is not retroactive--it would apply only to intangible assets purchased after its effective date. Because prior transactions were negotiated in reliance on existing law, we think it appropriate that any legislation be prospective in effect. While a prospective effective date will not resolve concerns involving purchased intangible assets that are subject to the current law, and will not eliminate IRS' difficulties with issues now in its inventory of open audit cases, a retroactive effect might undermine legitimate taxpayer expectations and weaken taxpayer confidence in the tax legislative process.

H.R. 3035 does not apply to self-created intangibles. While our report indicated that statutory cost recovery periods for all purchased intangible assets would raise the issue of the proper tax treatment of creation costs, we do not think it necessary to deal with that issue in this legislation.

Two other House bills address the amortization of a category of intangibles that has been troublesome for the IRS and taxpayers, those falling within the category that we identified as customer or market-based intangibles. H.R. 563 would treat such intangibles as having an indeterminant useful life, thereby eliminating amortization deductions for taxpayers' investments in assets such as core deposits and subscription lists. H.R. 1456 is intended to clarify current law standards for amortizing customer-based and similar intangible assets and would authorize the Treasury to develop safe-harbor recovery periods for these assets. Specifically, H.R. 1456 would allow amortization if the taxpayer can demonstrate that the asset has a value separate and distinct from other assets, including goodwill, and a limited useful life.

While the bills provide some guidance in determining which purchased intangibles are amortizable, both tinker with the definition of goodwill without changing its nonamortizable status. Consequently, while taxpayers would have additional guidance in determining which intangible assets may be amortized, controversies over whether particular intangibles are amortizable would likely continue. We also identified other problems with the proposed legislation. H.R. 563 could adversely affect the sales price of businesses that have invested heavily in customer-based intangibles, and result in the distortion of business income after the sale. Additionally, while H.R. 1456 provides for regulatory guidance on recovery period determinations, disputes over useful lives would likely continue if either of these bills were enacted.

In conclusion, we believe that it is time for legislative change to clarify the tax treatment of purchased intangible assets. We also believe the approach taken in H.R. 3035 is preferable to that of H.R. 563 or H.R. 1456.

This concludes my testimony. I would be pleased to answer any questions you may have.

Copies of GAO testimonies and reports are available upon request. The first five copies of any GAO report or testimony are free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Orders may also be placed by calling (202) 275-6241.