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Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets

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The Honorable Dan Rostenkowski
Chairman, Joint Committee on Taxation

The Honorable Lloyd Bentsen
Vice Chairman, Joint Committee on Taxation
Congress of the United States

This report responds to your request that we obtain information on how the purchase price for acquired businesses is allocated among intangible assets. We also discuss specific tax policy considerations identified during our review.

We are sending copies of this report to the Secretary of the Treasury and the Director of the Office of Management and Budget as well as to appropriate congressional committees and Members of Congress. Major contributors to this report are listed in appendix II.

If you have any questions on this report, please call me on (202) 275-6407.

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Purpose

One of the oldest controversies between taxpayers and the Internal Revenue Service (IRS) is the extent to which taxpayers can deduct the price they pay for intangible assets, such as customer or subscription lists. The opportunities for disputes to arise intensified during the 1980s when business acquisition activity increased and led to a growth in the reported values of intangible assets from about $45 billion in 1980 to $262 billion in 1987. As a result, billions of dollars of potential tax deductions and, therefore, tax revenues are still affected by decisions on whether tax deductions for intangible asset costs are permitted.

Recognizing the importance of this tax issue, the Joint Committee on Taxation asked GAO for information on the types of deductible intangible assets, the asset values and useful lives claimed, and the industries affected. GAO also explored various proposals for revising intangible asset tax rules, which have not significantly changed since 1927.

Background

Current tax rules allow taxpayers to deduct the cost of assets through periodic tax deductions known as depreciation or amortization. Tangible assets, such as buildings and equipment, are depreciated over specific statutory periods. For intangible assets, however, the rules are more complex. The general rule is that tax amortization deductions are taken over the useful life of each intangible asset. Taxpayers determine the specific useful life for each intangible asset separately.

Purchased goodwill and other intangible assets without determinable useful lives are not amortizable. The tax value of goodwill is the amount by which the purchase price exceeds the fair market value of the acquired company's individual assets, including identified intangible assets. Certain other intangible assets can be amortized over statutorily assigned useful lives. For example, patents may be amortized over a 17-year period, unless the taxpayer can show a shorter life.

The taxpayer's determination of useful life is only questioned when IRS performs an audit. IRS frequently contends that many intangible assets are in fact purchased goodwill and not amortizable. Taxpayers, however, assert that the assets are not goodwill, the determined useful lives are accurate, and the intangible assets are eligible for amortization. As a result, IRS and taxpayers must resolve disagreements on a case-by-case basis. Unresolved issues are ultimately decided by the courts on the basis of facts and circumstances. Court decisions have varied and have led to inconsistent treatment for similarly situated taxpayers.

An analysis of purchased intangible asset taxation also requires a familiarity with the treatment of costs incurred in creating such assets. Generally, costs of creating long-lasting assets are included, or capitalized, in the cost basis of the asset and deducted over the asset's life. Because some intangible assets, such as goodwill, are not normally considered distinct or traceable assets by taxpayers, most costs of creating them, like advertising expenses, are usually deducted in the year incurred rather than capitalized and amortized over the life of the asset. The result of these tax rules is that purchased goodwill is treated less favorably than other purchased assets, while the costs of creating goodwill are treated more favorably than creation costs of other assets. This unusual result must be kept in mind in devising solutions to the problems of intangible asset tax rules.

Results in Brief

GAO analyzed tax data IRS gathered in 1989 on all its unresolved, or open, purchased intangible asset cases. Taxpayers in nine industry groups had claimed deductions for 175 types of purchased intangible assets that they identified as different from goodwill and valued at $23.5 billion. IRS most frequently challenged the classifications rather than the useful lives and/or values that taxpayers assigned to these intangible assets. The disagreements occurred in most industries and primarily stemmed from differences in the tax treatment of goodwill, which is never amortizable, and other intangible assets that are amortizable.

GAO believes the disagreements between IRS and taxpayers over which intangible assets may be amortized will continue unless changes are made in the current rules. Recognition of all intangible assets that waste away over time and the development of guidelines for their amortization would help to prevent such disputes and provide uniform treatment for all taxpayers.

GAO's Analysis

Taxpayers Amortized Numerous Purchased Intangible Assets

GAO's analysis is based on data gathered by IRS in 1989 from all open cases involving purchased intangible asset issues in its examination, appeals, or litigation units. Generally, these cases involved tax years 1979 to 1987. To illustrate and analyze the conflicts these issues generate, GAO grouped the assets into the following seven categories:

- Customer- or market-based assets - Taxpayers valued this category at $10.5 billion; it was the largest category of intangibles. Examples included stable pools of deposits, called core deposits, held by financial institutions, and newspaper and magazine subscription lists. On average, taxpayers amortized these assets over 8.8 years. IRS' proposed adjustments totaled $4.1 billion.
- Contract-based assets - Taxpayers valued this category at about $3.7 billion. The category included assets supported by specific contracts, such as covenants-not-to-compete and leases. On average, taxpayers amortized these assets over 6.3 years. IRS' proposed adjustments totaled $1.2 billion.
- Technology-based assets - Taxpayers valued this category, which included assets such as computer software, drawings, and technical manuals, at $2.2 billion. On average, taxpayers claimed amortization over 6.4 years. IRS' proposed adjustments totaled $665 million.
- Statutory-based assets - Taxpayers valued these assets at $3.5 billion. These assets had specific statutorily defined amortization periods that could be elected in lieu of useful lives. Examples included patents and copyrights, and the average amortization period was 10.6 years. IRS' proposed adjustments totaled $341 million.
- Workforce-based assets - Taxpayers valued these assets at $1.1 billion. Assets in this category related to the existing workforce and included trained staff and technical expertise. On average, taxpayers amortized these assets over 6.6 years. IRS' proposed adjustments totaled $866 million.
- Corporate organizational/financial assets - Taxpayers valued these assets, which related to the organizational structure and the financial-based assets of the company, at $1.3 billion. Examples included acquisition costs, legal and auditing fees, and favorable financial arrangements. The average amortization period was 7.5 years. IRS' proposed adjustments totaled $358 million.
- Unidentifiable assets - This category included $1.2 billion of intangible assets that GAO could not classify because of an insufficient level of detail in IRS' data. The average amortization period was 8.9 years, and IRS' proposed adjustments totaled $498 million.

IRS Calls Intangible Assets Goodwill in 70 Percent of Cases

In 70 percent of the cases in which taxpayers claimed that intangible assets had a determinable useful life, IRS claimed that the assets were in fact goodwill and not amortizable. In total, IRS proposed adjustments of about $8 billion on the basis of its evaluation of the value, useful life, or classification of intangible assets. The final outcome of these cases will

depend upon IRS' or the courts' interpretation of facts related to each asset.

Tax Policy Considerations

In GAO's opinion, conflict between taxpayers and IRS regarding which purchased intangible assets are amortizable is likely to continue. The fact and circumstance based nature of the controversy leads to costly disagreements between taxpayers and IRS and inconsistent treatment for similarly situated taxpayers. A legislative change similar to the changes made to the tangible asset rules to address these same problems is needed. Keeping the current tax rules would mean accepting frequent and costly disagreements between taxpayers and IRS, with the courts acting as the final arbiter.

When these conflicts arise, they are caused by the disparity between the tax treatment of (1) goodwill and other nonamortizable intangible assets without determinable useful lives and (2) amortizable intangible assets with taxpayer-determined useful lives. This disparity gives taxpayers an incentive to establish values and useful lives for purchased intangible assets other than goodwill.

The current tax treatment of goodwill and similar intangible assets fails to recognize the economic benefits that wasting intangible assets contribute over time. These assets are consumed over time even if a precise period cannot be determined. Denying amortization deductions does not result in an accurate determination of taxable income since expenses are not properly matched to income generated. Recognition of these economic benefits over time for tax purposes can be accomplished by establishing specific statutory cost recovery periods for purchased intangible assets similar to those now used for tangible assets.

Providing specific cost recovery periods could, therefore, result in a more accurate measurement of income. It could also eliminate conflicts resulting from the nondeductibility of purchased goodwill and disagreements over the estimated length of useful lives.

Administrative concerns, such as the appropriate identification of the categories to which particular intangible assets belong and the calculation of asset values, should be considered when choosing the lengths of cost recovery periods and category definitions. These conflicts were not significant when compared to conflicts over goodwill but could increase as the number of categories eligible for amortization and the span of cost recovery periods increase.

The potential revenue consequences of this proposal depend upon specific design components. For example, a cost recovery system could gain revenue, be revenue neutral, or lose revenue, depending on the specific useful lives established. Statutory recovery periods for purchased intangible assets would also raise the question of the proper tax treatment of the costs incurred in creating intangible assets. Any new rules covering created intangible asset costs may also affect revenues.

Matters for Congressional Consideration

Congress should consider revising the current tax law to provide for amortization of purchased intangible assets, including goodwill, over specific statutory cost recovery periods.

Agency Comments

The views of responsible agency officials were sought during the course of GAO's work and have been reflected in the report where appropriate. They generally agreed with the facts presented.

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Abbreviations

ABA	American Bar Association
ACRS	Accelerated Cost Recovery System
FASB	Financial Accounting Standards Board
IRS	Internal Revenue Service

Introduction

A common method of acquiring a business is to purchase its assets. The purchase price in many asset acquisitions can exceed the fair market value of the acquired tangible assets, such as buildings, land, and equipment. The amount by which the purchase price exceeds the fair market value of the tangible assets represents the value related to intangible assets, such as customer lists, patents, and goodwill. The values assigned to the various types of intangible assets have significant potential tax consequences because the costs of some intangible assets may be recovered through annual tax deductions known as amortization, while the costs of other intangible assets, such as goodwill, are not recoverable at all. The tax value of goodwill is the amount by which the purchase price exceeds the fair market value of the acquired company's individual assets, including identified intangible assets.

Intangible asset costs can be amortized over the assets' useful lives if the assets can be separately identified and valued and if their specific useful lives can be determined. For certain intangible assets, like patents and copyrights, costs can be amortized over either the assets' useful lives or optional statutory cost recovery periods. Amortization is not allowed, however, for intangible assets like goodwill that do not have determinable useful lives. Disagreements between the Internal Revenue Service (IRS) and taxpayers about the useful life determinations of specific intangible assets have led to proposals for tax law changes that are designed to reduce the controversies.

According to information published by IRS' Statistics of Income Division, intangible asset values reported by corporations grew from $45 billion in 1980 to $262 billion in 1987. The increase generally reflected the growth in merger and acquisition activity during the period. As the reported values increased, increases in total amortization deductions for tax purposes were also reported. Many factors could affect the number and types of future corporate acquisitions. However, we believe that purchasing the assets of a business will continue to be a prevalent type of business acquisition.

Allocation of Purchase Price to Acquired Assets Plays an Important Role in Determining Tax Liability

The Tax Reform Act of 1986[1] set specific reporting rules that require both the buyer and seller to use the same method for assigning values to purchased assets. The buyer and seller must use the residual method to allocate purchase price. Under this method, the purchase price is allocated to four classes of assets according to their fair market values. The four classes of assets are:

- Class I - Cash demand deposits and their equivalents.
- Class II - Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency.
- Class III - All tangible and intangible assets other than Class I, II, and IV assets regardless of whether they are depreciable, depletable, or amortizable. These include furniture and fixtures, land, buildings, equipment, accounts receivable, and covenants not to compete.
- Class IV - Intangible assets like goodwill and going concern value.

Taxpayers have a financial incentive to allocate intangible assets to Class III because only Class III intangible assets are amortizable. Class III amortizable intangible assets must be separate from goodwill, be valued, and have determinable useful lives. Class IV intangible assets are in the nature of goodwill and are not amortizable.

Tax and Accounting Rules for Intangible Assets

For tax amortization purposes, different types of intangible assets are treated differently. The costs of purchased intangible assets may be amortized over the assets' determined useful lives. Some intangible assets, such as patents and copyrights, are statutorily assigned useful lives that can be used in lieu of determined useful lives. Goodwill and similar intangible assets that do not have determinable useful lives are not amortizable. The difficulty in determining useful life has been cited as a reason for disallowing amortization of these intangible assets.

Generally accepted accounting principles developed by the Financial Accounting Standards Board (FASB) recognize that the values of all intangible assets decrease, or waste, over time. Accordingly, the principles require that the costs of all intangible assets, including goodwill, be amortized on the basis of the assets' estimated useful lives. If no specific useful life can be determined, the asset is to be amortized over a period not to exceed 40 years.

[1]Public Law 99-514, section 201-203, 100 stat. 212 (1986).

Although the financial and tax accounting systems have different purposes, they coincide in their overall objective to accurately measure income. The purpose of financial accounting is to provide useful information to owners, creditors, and others who make economic decisions. The primary purpose of the income tax system is to raise revenues from taxpayers on an equitable basis to carry out social and economic policies. Although each system may use different technical rules to achieve their basic objectives, the accurate measurement of income is fundamental to both of these systems.

Alternatives Identified

Disagreements between IRS and taxpayers about whether specific acquired intangible assets are separate from goodwill and about assets' useful lives have led Members of Congress and various professional groups to propose several alternative changes in the tax law. We placed the alternatives into the following two groups:

- those providing easier qualification standards for the amortization of purchased intangible assets, sometimes including goodwill,[2] and
- those disallowing amortization by expanding the definition of goodwill to include specific purchased intangible assets or categories of intangible assets.[3]

In addition, the current tax law could remain unchanged, and disagreements between IRS and taxpayers could continue to be resolved on a case-by-case basis. The policy implications for each of these proposals are discussed in chapter 4.

Objectives, Scope, and Methodology

The Joint Committee on Taxation asked us for certain information regarding amortization of intangible assets. Specifically, the Committee asked us to provide information about

- the way in which acquirors have allocated purchase prices among intangible assets (including allocation between goodwill and other intangible assets);
- the various types of intangible assets (including customer lists and other customer- and workforce-based intangible assets) for which acquirors have claimed amortization;

[2]The current legislative proposals H.R. 1456 and S. 1245 contain elements of this group.

[3]The current legislative proposal H.R. 563 contains elements of this group.

- the periods over which intangible assets have been amortized for tax purposes; and
- the industries in which amortization of customer- or workforce-based intangible assets has been an issue.

We also determined the nature of IRS' proposed audit adjustments and explored various tax alternatives regarding the tax treatment of intangible assets and their implications. The alternatives and implications are discussed in chapter 4.

To develop the information the Committee requested, we independently evaluated responses to a 1989 internal IRS survey regarding amortization of intangible assets. The survey asked IRS offices nationwide to provide information as of mid-1989 on all unresolved, or open, audit cases in their examination, appeals, or litigation units. Generally, these cases included tax returns for tax years 1979 through 1987. The survey did not ask for information from unaudited tax returns or cases that had been closed. Table 1.1 shows the number of intangible asset open issues identified by the IRS survey. The number of open issues is the number of intangible asset amortization deductions IRS questioned on taxpayers' returns. Some taxpayers' returns contained multiple intangible asset deductions that IRS questioned.

Table 1.1: Intangible Asset Issues That Three IRS Units Reported as Open

IRS Unit	Number of issues
Examination	1,722
Appeals	366
Litigation	78
Total	**2,166**

IRS developed similar, but separate, survey instruments for each unit. IRS' National Office summarized and did a preliminary analysis of the survey responses. We did additional analysis to generate data on the allocation of purchase price among intangible assets, the type and number of intangible assets, claimed asset lives and values, and IRS' proposed audit adjustments. IRS had no existing data base from which to extract such information. Thus, data in this report were necessarily limited to those open cases for which IRS gathered the data. We did not verify IRS' individual region or district responses to the questions on the survey instruments.

The analysis of alternatives required a review of the historical tax and financial accounting treatment of both intangible assets and tangible assets. In addition, in order to understand the consequences of the different alternatives, we analyzed the impact of the interplay among tax and financial accounting rules and court decisions.

We interviewed officials from IRS, the Department of the Treasury, the Securities and Exchange Commission, FASB, the American Institute of Certified Public Accountants, the American Bar Association (ABA), the Tax Executives Institute, the National Association of Accountants, various asset valuation firms, and tax experts. We also reviewed research about intangible assets and met with researchers to obtain additional insight into how taxpayers identify and amortize intangible assets.

We did our work between April 1989 and June 1991 in accordance with generally accepted government auditing standards. Our work was done primarily in Washington, D.C., and Philadelphia.

The views of responsible agency officials sought during the course of our work and have been reflected in the report where appropriate.

Tax, Accounting, and Judicial Treatment of Assets

Tax rules governing the deductibility of the costs of acquired tangible and intangible assets differ considerably. For tangible assets, tax depreciation rules have evolved into a statutory cost recovery system. This system includes asset classifications and cost recovery periods. However, for intangible assets, tax amortization rules require the taxpayer to determine a specific useful life for each asset so that it can be amortized over that period.

Most of the current disagreements over the tax treatment of purchased intangible assets concern whether or not assets are separate from goodwill. Treasury regulations specifically provide that goodwill is nonamortizable. Taxpayers have sought to identify specific assets and determine useful lives for these assets so they are not classified as goodwill. IRS has challenged their positions by asserting that the assets are part of goodwill and not amortizable.

Tax and financial accounting rules fundamentally differ on the treatment of purchased goodwill. Generally accepted accounting principles recognize that the values of all intangible assets, including goodwill, decrease over time and, therefore, require that they be amortized over their useful lives. If a specific useful life cannot be determined, a specified maximum amortization period is to be used. Financial accounting principles also provide both general and specific guidance on the identification of intangible assets. Taxpayers can use this guidance in litigating tax cases.

IRS and taxpayers settle the disagreements that arise during examinations through the IRS appeals process or litigate the issues in the courts. The facts presented in each case are crucial in determining whether purchased intangible assets are amortizable. If the taxpayer establishes, to the satisfaction of IRS or to a court, that the useful life of an intangible asset can be determined and that the asset has an ascertainable value separate and distinct from goodwill, the asset is generally considered amortizable. Thus, the issue is settled on a case-by-case basis and only arises when IRS does an audit.

Tax Rules Provide More Certainty for Tangible Assets Than for Intangible Assets

The Internal Revenue Code allows deductions for depreciation and amortization in computing taxable income. Depreciation is defined as a deduction for exhaustion, wear and tear, and obsolescence of tangible assets. Amortization is a similar deduction that applies to intangible assets.

The rules governing depreciation of tangible assets have been repeatedly refined by Congress since the inception of the income tax. However, the amortization of intangible assets is still governed by tax rules that originally applied to both tangible and intangible assets in the Revenue Act of 1913. In addition, the Treasury regulations covering the treatment of goodwill have not changed significantly since 1927.

The legislative and administrative histories of the rules governing the depreciation of tangible assets show that many of the changes were designed to eliminate the types of problems that taxpayers and IRS now encounter in the amortization of intangible assets. Provisions governing depreciation of tangible assets have evolved into a system of guidelines for deducting costs over capital cost recovery periods designed, in part, to reduce disagreements between IRS and taxpayers. In contrast, purchased intangible assets are still amortized over their individual useful lives as determined by taxpayers.

Evolution of Tangible Asset Depreciation Rules

The Revenue Act of 1913 allowed depreciation only on assets that were subject to exhaustion and wear and tear through use in the business. Under the act, tangible assets were depreciated over periods equaling the estimated useful life of each asset as determined by the taxpayer. Specific guidance interpreting the statutory requirement was not published for 20 years, allowing taxpayers considerable leeway in interpreting the law.

Treasury regulations published in 1934 required taxpayers to justify the useful lives for assets on the basis of the particular situation of the taxpayer. Because the tax rules required taxpayers to determine useful lives, rather than providing fixed economic useful lives or guidelines as the basis for depreciation deductions, difficulties and controversies arose with respect to uniformity in the administration of depreciation provisions. In response, depreciation guidelines were developed that included estimated useful lives and depreciation rates for various types of tangible assets classified by type of industry. These estimates were published in 1942 as Bulletin F, which IRS used until 1962 as guidance in doing audits. The bulletin was only a guide and could not be used to

sustain a claimed deduction without evidence that the guide generally matched the taxpayer's situation. Once this requirement was met, the guidelines could be used. The taxpayer was also required to show that the guide did not match the facts and circumstances for the business if shorter depreciation periods were used.

In 1962 Revenue Procedure 62-21 replaced Bulletin F. The revenue procedure was designed to provide taxpayers with a greater degree of certainty in determining useful lives and to produce greater uniformity in the results of audits of depreciation deductions. The new procedure established classes of assets with a guideline life for each class. Shorter lives than those allowed under the procedure were permitted if justified. The revenue procedure reduced the potential for conflict by allowing taxpayers to use the class lives for assets if they could show that the class lives were consistent with their asset retirement policies. A new technical formula, known as a "reserve ratio test," was used to determine if the taxpayer's retirement policies were consistent with the guidelines. If this new technical test was not met, the taxpayer was required to prove the accuracy of the depreciation periods on the basis of the facts and the circumstances.

In 1971, Congress again revised depreciation policies by adopting the Asset Depreciation Range System, which in part was designed to correct administrative problems involving useful life determinations. The system provided elective ranges of 20 percent above or below the useful life guidelines and was crafted to recover capital costs faster than the older system. IRS could not challenge taxpayers' useful life determinations that fell within the established ranges.

In 1981, the Accelerated Cost Recovery System (ACRS) was enacted as part of the Economic Recovery Tax Act. ACRS was designed to further simplify the depreciation of tangible assets by providing a number of reforms, including more accelerated capital cost recovery periods. The act made the most significant revision of the tax depreciation rules to date by generally requiring the use of fixed recovery periods. This change eliminated the optional use of taxpayer-determined useful lives for many assets. Under ACRS, taxpayers divided tangible assets into four categories, ranging in useful lives from 3 to 15 years. The categories were modified during the early and mid-1980s. Other depreciation factors were also revised in 1981. For example, salvage value is no longer considered when determining depreciation deductions for tangible assets.

The evolution of tangible asset tax depreciation rules illustrates how Congress resolved the complexity and difficulty found with useful life determinations. Any benefits of asset-by-asset determinations were forgone in favor of a more uniform system. For example, all items such as horses are depreciated over the same period regardless of the age or condition of the horse when acquired or created.

Evolution of Intangible Asset Amortization Rules

Income tax treatment of intangible assets remains subject to statutory rules enacted in 1913 and slightly revised in 1918. Owners of these assets did not benefit from the tangible asset reforms designed to eliminate disagreements between IRS and taxpayers. The original Revenue Act of 1913 provided deductions for the exhaustion and wear and tear of assets arising out of their use or employment in the business. The Revenue Act of 1918 changed the provision by allowing deductions for the exhaustion and wear and tear of assets used in the trade or business. Some commentators have suggested that this change from the term "use or employment" to "used in the trade" broadened the provisions to allow for the amortization of intangible assets that cannot be physically exhausted by use in the business. We were unable to accurately determine the meaning (if any) of the differences in the language of the two acts.

The first authoritative interpretation of the statutory language occurred in administrative regulations. In 1927, the Department of the Treasury published regulations containing the first statement that goodwill is not amortizable. Goodwill was generally viewed as having an indeterminable useful life. Without a determinable useful life, there was no period over which to recover the asset's cost, and, therefore, no deduction could be calculated or allowed under the statutory provision. The regulations have not changed with regard to goodwill.

Financial Accounting Amortization of Intangible Assets Differs Fundamentally From Tax Treatment

Generally accepted accounting principles promulgated in 1970 rely on the same basic useful life concepts as those used in the income tax system for amortizing acquired intangible assets. The basic financial accounting principles require that all wasting intangible assets purchased in an acquisition, including goodwill, must be recognized as separate assets and be amortized over their useful lives. The fundamental difference is that tax rules do not allow amortization of goodwill. If the useful life of the goodwill or other assets cannot be reasonably estimated, the assets are to be written off for financial accounting purposes over a period that is no longer than 40 years. The general accounting

rules requiring the identification of intangible assets that can be distinguished from goodwill and also requiring their separate amortization are supplemented by a variety of specific rules that provide guidance on how to treat particular types of intangible assets.

Under current accounting rules there are four basic factors used in classifying an intangible asset. These factors assess the identifiability of the asset, the manner of acquisition, the expected period of benefit, and the separability of the asset from the entire enterprise. After the asset is classified as separate from goodwill, the asset's useful life can be determined by using seven general factors. These factors cover limitations on the asset, such as legal or contractual provisions, and options for renewing or extending the use of the asset. Other factors affecting the asset, such as competition, obsolescence, and actions by others that may restrict competitive advantages, are also used to measure the asset's useful life.

The basic rules for classifying and valuing intangible assets have been supplemented over the years by accounting pronouncements that provide more detailed guidance on how to apply the principles to specific assets. One pronouncement deals with acquisitions of banking and thrift institutions. Other pronouncements concern the identification and valuation of government regulated business operations and mortgage servicing rights.

Because the useful life requirements are basically similar in the tax and financial accounting rules for intangible assets, generally accepted accounting principles offer taxpayers a possible approach for amortizing intangible assets other than goodwill for tax purposes. The basic accounting guidance for separating an asset from goodwill and the methods for determining useful life and value are similar to the tax law requirements for deductibility. However, IRS has not always agreed with tax treatment resulting from accounting approaches, and the disagreements have led to litigation.

Court Decisions Illustrate Problems of Intangible Asset Amortization

The absence of a definition for goodwill in the tax code and regulations has led the courts to define goodwill both in terms of its characteristics and its contribution to business profits or value. Some courts have defined goodwill as the ability of a business to generate income in excess of a normal rate on assets due to superior managerial skill, market positions, or new product technology. Other courts have specifically linked

goodwill with the expectation that customers will continue to buy a company's goods or services.[1]

The courts determine whether specific intangible assets are separate from goodwill and thus entitled to amortization if they have a determinable useful life and value. The absence of an adequate definition for goodwill in the regulations has resulted in inconsistent court decisions. In some instances, courts have refused to permit amortization of intangible assets because they agreed with IRS that the assets were part of goodwill. In other cases, courts have permitted deductions for the same types of assets because they believed that the assets were not the same as goodwill. Still other courts have denied amortization deductions claimed in particular cases but have suggested that if taxpayers presented better statistical evidence on the assets' useful lives, amortization might be permitted. As the following discussion shows, confusion over the meaning of goodwill sometimes causes similarly situated taxpayers to be treated differently.

Customer-Based Assets Illustrate IRS' Position and Conflicting Court Decisions

Customer-based assets provide an example of these conflicting decisions by the courts. In General Television, Inc. v. United States, 449 F. Supp. 609 (D. Minn. 1978), aff'd per curium 598 F. 2d 1148 (8th Cir. 1979), for example, the court concluded that the taxpayer could not amortize subscription lists because the purchase of the lists was actually purchase of expectancy that customers would continue buying the company's services, one of the definitions of goodwill. In a more recent case, Newark Morning Ledger Co. v. U.S., 734 F. Supp. 176 (D.N.J. 1990), the district court ruled for the taxpayer, holding that the subscription lists acquired by the purchaser of a newspaper were assets separate and apart from goodwill and had limited useful lives. The court reasoned that, over time, subscribers are lost as a result of relocation, lack of reader interest, and dissatisfaction with the product or service.

The treatment of another customer-based intangible asset, core deposits,[2] also highlights the inconsistency in court decisions. IRS' position is that core deposits represent intangible assets that are inseparable from goodwill and thus not amortizable for tax purposes. In AmSouth Bancorporation v. United States, 681 F. Supp. 698 (N.D. Ala. 1988), a federal district court ruled that a core deposit base acquired as part of

[1] Boe v. Commissioner, 307 F.2d 339, 343 (9th Cir. 1962).

[2] Core deposits represent the present value of the future cost savings from acquiring low-cost bank deposits instead of more expensive sources of investment funds.

the purchase of a bank was not separate and distinct from goodwill and, hence, was not amortizable for tax purposes. However, in Citizens and Southern Corporation and Subsidiaries v. Commissioner 91 T.C. 463 (1988), the Tax Court ruled that the acquired core deposits were amortizable even though they had been acquired as part of the purchase of a bank. In the latter case, Citizens and Southern Corporation hired a valuation expert who valued the core deposits on the basis of the available market rate of return. The Tax Court found that the principal value of the core deposits was not the part of goodwill, but Citizens and Southern's ability to use cash deposits as a low-cost source of lending funds.

Conclusions

Current depreciation rules for tangible assets have evolved to reflect administrative considerations and the need for consistent tax treatment of taxpayers. In contrast, the current tax treatment of intangible assets is based on the original income tax law and decades of conflicting court decisions, and it is contrary to generally accepted accounting principles. The vague definition of goodwill, as well as taxpayers' latitude in determining useful life, has led to frequent disputes between taxpayers and IRS. Some of these disagreements have been resolved in the courts, where the decisions have been influenced by the most convincing evidence. This situation has resulted in inconsistent treatment of similarly situated taxpayers.

Taxpayers in Nine Industry Groups Amortized Numerous Purchased Intangible Assets That Were Challenged by IRS

Our analysis of nationwide data gathered by IRS during 1989 for all open intangible asset issues revealed that taxpayers in nine major industry groups claimed amortization deductions that were challenged by IRS. Taxpayers had valued the intangible assets in these open issues at over $23 billion. Most of these open issues involved the categorization of assets as goodwill. In about 70 percent of the cases, IRS challenged taxpayers primarily on the classification of assets as intangible assets other than goodwill. In the other 30 percent, IRS challenged the taxpayers' determinations of value and/or useful life. In total, our analysis showed that IRS had proposed adjustments of over $8 billion for these cases.

Taxpayers Identified Many Types of Intangible Assets

Our analysis of data gathered by IRS identified 2,166 open audit issues in its examination, appeals, and litigation units. These issues included 175 different types of intangible assets identified and claimed as amortizable by taxpayers.

We grouped the 175 different types of intangible assets into the seven categories shown in table 3.1 to illustrate and analyze the conflicts. A description of each category follows the table.

Table 3.1: Number and Percentage of Intangible Asset Open Issues by Category in Three IRS Units

Category	Examination		Appeals		Litigation		Combined	
Customer/market	565	33%	171	47%	40	51%	776	36%
Contract	434	25	91	25	9	12	534	25
Technology	217	13	33	9	5	6	255	12
Statutory	169	10	39	11	21	27	229	11
Workforce	163	9	18	5	1	1	182	8
Organizational/ financial	115	7	8	2	2	3	125	6
Unidentifiable	59	3	6	2	0	0	65	3
Total	**1,722**	**100%**	**366**	**100%[a]**	**78**	**100%**	**2,166**	**100%[a]**

[a]Totals do not add to 100 due to rounding.

- Customer/market-based intangible assets - This was the largest category and included intangible assets that related to the customer structure or market factors of a business. Examples included stable pools of deposits, called core deposits, underdeveloped markets, and customer and subscription lists.
- Contract-based intangible assets - This was the next largest category and included those intangible assets that have a fixed or definite term, such as contracts, leases, and covenant-not-to-compete agreements.

- Technology-based assets - These intangible assets related to innovations or technological advances within the business. Examples included computer software, formula processing procedures, unpatented know-how, and drawings and technical manuals.
- Statutory assets - These intangible assets had statutorily established useful lives, such as copyrights, patents, franchises, and trademarks. For example, patents may be amortized over a 17-year period unless the taxpayer can show a shorter life.
- Workforce-based assets - These intangible assets related to the value of the established employees or workforce of a company. Examples included assembled workforce, trained staff, and technical expertise.
- Corporate organizational/financial assets - These intangible assets represented the organizational structure of a specific company and its related financial instruments. For example, deferred organization costs, legal and auditing fees, acquisition costs, and favorable financing agreements were in this category.
- Unidentifiable assets - These were intangible assets that we could not include in one of the other six categories because of insufficient detail in IRS data.

The above categories were chosen to illustrate the nature of the open issues for analysis purposes only. For example, issues involving intangible assets with optional statutory amortization periods were placed in a separate category because conflicts over whether the assets were goodwill would not arise as often.[1] We did not obtain detailed descriptions of the intangible assets claimed by taxpayers. The intangible asset names, identified by IRS as having been claimed by taxpayers, are only an indication of what the assets are. We also were not able to analyze the amortization schedules or valuation methods that taxpayers used because such schedules and methods were not included in the survey instruments.

Appendix I contains a detailed listing by name of the intangible assets reported by IRS. Goodwill, which is not amortizable, is not included in table 3.1 or appendix I and could constitute another category of intangible assets.

[1]Goodwill conflicts involving statutory assets may occur if the status of the asset, such as a patent or copyright, is in dispute.

Taxpayers Allocated a Significant Portion of the Purchase Price to Intangible Assets Other Than Goodwill

The allocation of the purchase price for an acquired business to various types of intangible assets is an important tax issue because taxpayers may be able to claim amortization deductions for some intangible assets but can never amortize acquired goodwill or other intangible assets without determinable useful lives. Taxpayers whose cases were included in IRS' survey assigned a value of $23.5 billion to intangible assets they identified as amortizable. Table 3.2 summarizes the dollar values by category of intangible asset.

Table 3.2: Total Taxpayer-Claimed Values Assigned to Intangible Asset Categories in Three IRS Units

Dollars in millions

Category	Total claimed value	Percentage
Customer/market	$10,549	45
Contract	3,665	16
Technology	2,180	9
Statutory	3,468	15
Workforce	1,169	5
Organizational/financial	1,304	6
Unidentifiable	1,172	5
Total	**$23,507**	**100[a]**

[a]Total does not add to 100 due to rounding.

Data from the survey in IRS' appeals unit, the only survey group that had purchase price allocation information, showed that, in 325 instances, taxpayers assigned, on average, 23 percent of the purchase price to intangible assets other than goodwill and 7 percent to goodwill. Allocations to goodwill ranged from 0 percent in one case to 37 percent in another. Table 3.3 shows the distribution of open issues in the appeals unit among various percentage-of-purchase-price-allocation ranges.

Table 3.3: Intangible Asset Categories in IRS' Appeals Unit by Percentage of Purchase Price Allocation

Category	Percentage range				Total
	0% < 25%	25% < 50%	50% < 75%	75% or more	
Customer/market	102	35	12	17	166
Contract	49	10	5	6	70
Technology	25	5	2	[a]	32
Statutory	20	8	6	2	36
Workforce	14	[a]	[a]	[a]	14
Organizational/ financial	6	1	[a]	[a]	7
Total	**216**	**59**	**25**	**25**	**325**

[a]Insufficient detail in IRS data to analyze.

Taxpayers Amortized Intangible Assets Over an Average Period of 8 Years

Amortization of an intangible asset is allowed if taxpayers can show that the asset is separate from goodwill and can prove with reasonable accuracy the asset's economic useful life. Table 3.4 shows the taxpayers' average claimed useful life by category as reported in IRS survey instruments.[2] On average, taxpayers amortized the assets over a period of 8 years.

Table 3.4: Average Taxpayer-Claimed Life for IRS' Open Issue Cases

Category	Examination		Appeals		Litigation		Combined	
	Cases	Average claimed life[a]	Cases	Average claimed life[a]	Cases	Average claimed life[a]	Cases	Average claimed life[a]
Customer/market	493	8.6	144	9.9	40	8.6	677	8.8
Contract	362	6.2	70	6.4	9	6.1	441	6.3
Technology	185	6.4	23	6.4	3	2.3	211	6.4
Statutory	130	9.9	26	17.0	19	14.4	175	10.6
Workforce	130	7.0	16	3.3	1	7.0	147	6.6
Organizational/ financial	98	6.9	7	15.3	[b]	[b]	105	7.5
Unidentifiable	36	8.8	6	9.3	[b]	[b]	42	8.9
Total	**1,434**		**292**		**72**		**1,798**	**7.8**

[a]Claimed life in years.

[b]Insufficient detail in IRS data to analyze.

[2]Some survey instruments did not contain information about claimed useful life.

Intangible Asset Conflicts Are Present in Nine Industries

Open issue intangible asset conflicts were present in nine industries that have experienced mergers and acquisitions. Of the 1,722 open intangible asset issues identified in the examination unit, IRS had identified the principal business activity for 1,378. Table 3.5 shows how the 1,378 open issues were distributed among industry groups. The principal business activity was not identified for open issues in the appeals and litigation units.

Table 3.5: Distribution by Industry Group of Open Issues in IRS' Examination Unit

	Industry groups		
Category	**Manufacturing**	**Finance, insurance, real estate**	**Services**
Customer/ market	129	178	96
Contract	132	57	64
Technology	86	38	23
Statutory	68	23	6
Workforce	51	38	28
Organizational/ financial	32	24	14
Unidentifiable	14	6	23
Total	**512**	**364**	**254**

Industry groups						
Transportation	Retail	Wholesale trade	Mining	Agriculture	Construction	Total
60	14	2	2	[a]	[a]	**481**
55	15	8	2	[a]	3	**336**
8	4	1	1	[a]	[a]	**161**
14	20	1	3	1	[a]	**136**
6	2	1	[a]	[a]	[a]	**126**
15	3	1	[a]	2	[a]	**91**
4	[a]	[a]	[a]	[a]	[a]	**47**
162	**58**	**14**	**8**	**3**	**3**	**1,378**

[a]No response reported by IRS.

IRS Questioned a Substantial Portion of Intangible Asset Amortization Deductions

For the open issues in IRS' survey, IRS has proposed adjustments that include (1) total disallowance of amortization deductions, (2) changes to the values assigned to intangible assets, and (3) changes in intangible assets' useful lives. As table 3.6 shows, these proposed adjustments have been substantial.

Table 3.6: Total Proposed Adjustments by Category for Three IRS Units

Dollars in millions

Category	Total number of open issues	Proposed adjustments	Percentage
Customer/market	607	$4,122	51.3
Contract	356	1,182	14.7
Technology	152	665	8.3
Statutory	148	341	4.2
Workforce	116	866	10.8
Organizational/ financial	98	358	4.5
Unidentifiable	32	498	6.2
Total	**1,509**	**$8,032**	**100.0**

In 70 percent of the survey issues in which taxpayers claimed that intangible assets had determinable useful lives, IRS claimed that the intangible assets were equivalent to goodwill and, therefore, were not amortizable. In the remaining 30 percent of the issues, IRS generally agreed with the taxpayers and allowed amortization. The 70 percent of conflicts over goodwill and the remaining 30 percent of conflicts over

the life and/or value of assets are analyzed by category in table 3.7. In some cases IRS adjusted the lives slightly as shown in table 3.8. We could not determine from IRS survey data why IRS adjusted the useful lives of some intangible assets and not others. We also could not distinguish how much of a recommended dollar adjustment was due to useful life calculations and how much was due to value calculations because single amounts were entered on the survey instruments.

Table 3.7: Relative Proportion of Open Issues

	Goodwill issues	Percentage	Life and/or value issues	Percentage	All issues	Percentage
Customer/market	370	45.7	96	26.8	466	39.9
Contract	159	19.6	116	32.4	275	23.5
Technology	67	8.2	60	16.8	127	10.8
Statutory	58	7.1	37	10.3	95	8.1
Workforce	81	10.0	11	3.0	92	7.8
Organizational/ financial	52	6.4	27	7.5	79	6.7
Unidentifiable	22	2.7	10	2.8	32	2.7
Total	**809**	**100.0[a]**	**357**	**100.0[a]**	**1,166**	**100.0[a]**

[a]Totals do not add to 100 due to rounding.

Table 3.8: Comparison of IRS and Taxpayer Useful Life Determinations in Cases in Which IRS Allowed Amortization
(Life in Number of Years)

	Examination		Appeals		Litigation	
Category	**Average claimed life**	**Average adjusted life**	**Average claimed life**	**Average adjusted life**	**Average claimed life**	**Average adjusted life**
Customer/market	9.4	10.8	8.6	9.3	12.0	12.0
Contract	6.7	7.2	7.0	7.0	8.5	8.5
Technology	5.5	6.8	6.1	6.7	1.0	5.0
Statutory	11.2	11.9	11.8	11.6	[a]	[a]
Workforce	[a]	[a]	3.6	5.4	[a]	[a]
Organizational/ financial	5.9	9.1	14.8	14.3	[a]	5.0
Unidentifiable	7.6	7.6	5.3	5.3	[a]	[a]

[a]Insufficient detail in IRS data to analyze.

Conclusion

Tax rules regarding the amortization of intangible assets have resulted in numerous disputes between IRS and taxpayers. Taxpayers have an incentive to identify assets that are separate from goodwill because they may qualify for amortization. However, IRS views most of the assets in

its open issue cases as equivalent to goodwill and therefore not amortizable at all. The data showed that 70 percent of IRS' proposed adjustments were based on classification of the intangible assets as equivalent to nonamortizable goodwill. We believe the data illustrate the results of the disparity between full cost recovery of some intangible assets and no cost recovery for purchased goodwill and its equivalents.

Agency Comments

The views of IRS staff were sought during the course of our work. They generally agreed with the facts presented but cautioned us that it is possible that district offices did not report all open cases in their examination, appeals, and litigation units. We recognize this possibility, but it does not affect our conclusions because they only pertain to the cases that were reported.

Tax Policy Alternatives, Conclusions, and Matters for Congressional Consideration

Current tax rules for amortizing intangible assets, which totally disallow amortization deductions for some wasting intangible assets and allow taxpayer discretion in determining amortization periods for others, have led to disputes between IRS and taxpayers that could only be resolved by the courts. Policy alternatives have been proposed or identified to address this situation. Current proposals for change fit into the following two categories:

- One group of proposals would expand amortization of purchased intangible assets that waste over time, sometimes including goodwill. These proposals provide easier qualification standards for amortization by either restricting the definition of goodwill or using one or more predetermined cost recovery periods for amortization.[1]
- The other group of proposals would disallow amortization for specific purchased intangible assets or categories of intangible assets by "deeming" them to have indeterminable useful lives.[2]

In addition, the current situation could be allowed to continue with no changes in the tax rules for amortizing intangible assets.

There are two basic policy questions that are paramount in considering any revisions to the current tax rules for amortizing intangible assets. First, will the revision improve the matching of business expense with revenue to better reflect income for the period? Second, will the change lessen the administrative burden on the taxpayer and IRS? In many instances, current rules do not result in the proper matching of expense and revenue and are unduly burdensome to administer. To the extent that changes in the tax rules allow taxpayers to amortize wasting intangible assets over specified periods that approximate the assets' economic useful lives, income will be properly measured. Implementation of such rules also should help reduce costly disagreements between taxpayers and IRS.

[1] Legislative proposals H.R. 1456, H.R. 3035, and S. 1245 include elements of this category.

[2] Legislative proposal H.R. 563 includes elements of this category.

Expanding Amortization of Purchased Intangible Assets

There are several ways to expand amortization of purchased intangible assets. We have concluded that a comprehensive approach that categorizes intangible assets, including goodwill, and assigns a specific cost recovery period to assets is the preferable method to adopt. If this policy were adopted, intangible asset amortization deductions would be similar to the tangible asset depreciation deductions under current tax rules.

This policy would be in accordance with the financial accounting standard that recognizes the value of all purchased intangible assets, including goodwill, that are consumed over time and, thereby, contribute to a business' ability to generate revenue. To the extent that an intangible asset's annual amortization rate based on the cost recovery period approximates the asset's decline in value, the objective of matching business expense and revenue would be met.

We believe that it is possible to determine reasonable cost recovery periods for intangible assets. Analysis of intangible asset data provided to IRS by taxpayers could provide a good basis for developing accurate cost recovery periods. IRS began capturing information on newly purchased intangible assets on Form 8594, which was first available in July 1988. Taxpayers were to use the form to provide information about acquisitions occurring in a tax year for which the due date of the return is on or after September 13, 1988. However, the filed forms are not readily usable because they have not been separated from corporate returns and tabulated. If all forms received in the future are centrally filed, they will eventually provide IRS a potential data base for identifying claimed intangible assets, their values, and their useful lives. Follow-up studies on the various methods used to amortize and value the intangible assets reported on these forms may also be helpful.

The extent of information about intangible assets will affect the degree of specificity that can be incorporated into a capital cost recovery system. The more specifically assets can be identified, the more accurately amortization deductions can be matched to revenues. Accomplishing the objective of matching business expense with revenue would have to be balanced against the possible consequences of having large variations in cost recovery periods. Otherwise, taxpayers might have an incentive to classify or overvalue intangible assets in categories with shorter recovery periods to accelerate their tax deductions. These administrative concerns will be less significant if the identity and value of the asset are less susceptible to manipulation. For example, if it is known that there are readily comparable assets that are bought and sold

by unrelated parties, a wider variance in recovery periods could be used because it is more likely that the asset will be accurately identified or valued.

While the specified cost recovery periods may not bring about perfect matches, allowing some amortization deductions over time for all wasting intangible assets could easily result in matches that are better than those that occur under current tax rules. These rules fail to give any recognition to the wasting value of some intangible assets. Allowing amortization of all purchased intangible assets over specified cost recovery periods also would provide taxpayers with an element of certainty that would reduce their administrative burden. Taxpayers would know the periods over which to amortize purchased intangible assets, and they would no longer need detailed analyses to establish asset lives for tax purposes. In such a system, the potential for disputes between IRS and taxpayers would be lessened, thereby reducing IRS' administrative burden as well. Another result would be more consistent treatment of similarly situated taxpayers because the taxpayer's judgment would play a far less significant role in determining amortization deductions than it does under current tax rules.

Providing specific cost recovery periods for intangible assets may lead to another possible benefit. Taxpayers may be prevented from deducting as current expense certain purchased intangible asset costs that should be amortized for tax purposes following a business acquisition. We have been told that taxpayers may expense certain intangible asset costs after an acquisition for financial accounting purposes because this procedure can improve operating results. At the same time, this practice may cause taxpayers to inappropriately accelerate tax deductions, which could be prevented if amortization of these costs were required over specific cost recovery periods.

International Competition

We believe that, in addition to fulfilling the two major objectives of improving income measurement and reducing administrative burdens, allowing amortization of all intangible assets, including goodwill, could enhance the international competitiveness of U.S. businesses. As we discussed in a previous report,[3] the tax deductibility of goodwill costs might provide advantages to foreign corporations by improving after-tax cash flow. However, we also reported that it would be difficult to

[3] Foreign Investment: Country Differences in Accounting for Takeover Costs (GAO/NSIAD-88-56BR, Dec. 28, 1987).

quantify the extent of a competitive advantage due to a change in the tax treatment of goodwill without a study of each country's tax system. A 1990 analysis by members of the American Bar Association (ABA) showed that 12 of 28 countries allowed tax amortization of goodwill and some other intangible assets. The countries that permitted some form of amortization included some major trading partners of the United States. The ABA Section on International Law and Practice has proposed that U.S. tax rules be changed so that all purchased intangible assets, including goodwill, can be amortized. This proposal agrees with the position of certain members of the ABA Tax Section, who have also recommended similar treatment for all purchased intangible assets.

Tax Policy Considerations Related to Costs That Create Intangible Assets

Changing the tax treatment of purchased intangible assets raises the issue of the tax treatment of costs that create intangible assets. A consequence of the current tax rules is that expenditures that create or enhance intangible assets frequently receive more favorable treatment than expenditures incurred in connection with the purchase or creation of tangible capital assets or the purchase of intangible assets. Over time, all assets contribute to a business' ability to generate revenue. However, the tax treatment of costs to create many intangible assets does not reflect the long-term contribution of those assets.

A capital expenditure is one that is expected to produce returns for future years, while a current expense is devoted to income production in the current year or other immediate needs. For tax purposes, capital expenditures are recoverable over the life (or capital cost recovery period) of the assets they create, while current expenses are generally deducted when incurred. However, many capital expenditures that create or enhance long-lasting goodwill (or assets that are functionally equivalent to goodwill) are treated as business expenses and deducted in the current tax year. For example, IRS allows a current deduction for most advertising expenses even though the benefit may extend beyond the year in which the cost is incurred. Taxpayers may expense costs associated with some intangible assets, such as advertising that creates goodwill, because, in accordance with judicial interpretations, these intangible assets are not usually considered to be distinct or traceable. An additional reason for this treatment for certain assets may be that it is difficult to determine how much of an expense contributes to the intangible asset and when the asset is created.

A change that would allow recovery of the cost of all purchased intangible assets, including goodwill, would alter the treatment of goodwill

for the first time since 1927 and would create uncertainty about the future treatment of expenditures that create goodwill and similar assets. The 1927 regulations disallowing amortization of goodwill have influenced the treatment of intangible asset creation costs by taxpayers, IRS, and the courts. Clarification of the future treatment of such expenditures, even if no change is desired, may be necessary to avoid confusion.

Proposed New Methods to Expand Amortization

Two bills, H.R. 1456 and S. 1245, contain virtually identical legislation and are entitled the Intangible Amortization Clarification Act of 1991. They would revise the tax rules for amortizing customer-based and similar intangible assets. The bills would allow amortization over the asset's useful life if the taxpayer can demonstrate through any reasonable method that the assets have (1) a value separate and distinct from other assets acquired as part of the same transaction and (2) a limited useful life that can be reasonably estimated. The bills' standards for amortization are similar to those of current law, as developed through IRS rulings and court decisions. However, because the bills allow the use of any reasonable method to establish useful life and value, they may give taxpayers more latitude in identifying and amortizing customer-based intangibles.

The bills also authorize Treasury to provide guidance by specifying "safe harbor" recovery periods consistent with industry practice and experience[4] or actual useful lives[5] for specific types of intangible assets. In addition, they permit Treasury to draft rules concerning how the intangible assets may be valued separately and distinctly from goodwill and other assets. Regulatory guidelines could lessen disputes between taxpayers and IRS over appropriate valuation and useful life determinations. However, H.R. 1456 and S. 1245 do not change the status of goodwill. The bills continue to base amortization on taxpayer-determined useful lives and asset classifications. As a result, income will not be measured as accurately as possible, and disputes are likely to continue. Additionally, similarly situated taxpayers may continue to be treated differently, depending on how Treasury guidance is structured and interpreted and whether or not the taxpayer is audited.

A third bill, H.R. 3035, was introduced on July 25, 1991. This bill would revise the tax rules to require that most purchased intangible assets,

[4] H.R. 1456.

[5] S. 1245.

including goodwill, be amortized over 14 years. It would not change the tax treatment of costs that create intangible assets. Although we have not done a detailed analysis of the provisions of the bill, we believe the change proposed in the bill would lessen the administrative burden on the taxpayer and IRS. It could also improve the matching of business expense with revenue to the extent that (1) previously nonamortizable, wasting intangible assets become amortizable and (2) the 14-year period approximates the actual average useful life of intangible assets.

Disallowing Amortization of Certain Purchased Intangible Assets

Disallowance of amortization for specific intangible assets that appear to be similar to goodwill, such as customer lists, would be accomplished by deeming such assets to have indeterminable useful lives. In addition, goodwill would continue to be nonamortizable. Such a proposal was included in the House version of the Omnibus Budget Reconciliation Act of 1987 but was deleted in conference. The House Ways and Means Committee reported that IRS lacked sufficient resources to challenge amortization of customer-based intangible assets or similar items. The House adopted the proposal to prohibit the amortization of such assets to ease IRS' burden by eliminating some of the disputes between IRS and taxpayers. In 1991, a new bill, H.R. 563, was introduced that would also prohibit amortization of customer-based and similar intangible assets.

Disallowing amortization of any wasting purchased intangible asset would not result in the proper matching of business expense and revenue. The economic contribution of these intangible assets would not be recognized because amortization expenses would not be deducted from the revenue that the intangible assets helped generate. In addition, taxpayers would still have an incentive to inappropriately allocate purchase prices to other intangible assets that are amortizable. Thus, disputes between IRS and taxpayers could continue.

Further, this policy alternative could result in disparate treatment of businesses that make acquisitions that include substantially different amounts of nonamortizable wasting intangible assets. Even if all other economic factors are equal, such businesses would have higher taxable incomes than businesses that make acquisitions that include more amortizable or depreciable assets. In addition, this alternative could create an economic bias against nonamortizable intangible assets. This bias could have detrimental effects on the purchase prices of businesses that have large amounts of such assets or could adversely affect acquisition decisions that make good economic sense otherwise.

Maintaining Current Tax Rules for Purchased Intangible Assets

One advantage of maintaining current tax amortization rules, according to those who do not believe that a change is needed, is that taxpayers generally determine the value and amortization period for purchased intangible assets. If unbiased, taxpayers might provide the best estimate of actual value and economic useful life because they are the ones most knowledgeable about how purchased intangible assets will contribute to their particular businesses. However, we believe that taxpayers' determinations could be influenced by their tax consequences.

Another advantage of maintaining current rules is that current tax rules for intangible assets are in accordance with financial accounting standards for determining the useful lives of assets. Therefore, taxpayers should use the same useful life determinations for tax and financial reporting purposes. This conformity, according to the American Institute of Certified Public Accountants, serves as a check against amortizing intangible assets for tax purposes over useful lives that are too short. However, we believe that in spite of the conformity, taxpayers have an incentive to amortize assets over a short time period for tax purposes. Tax consequences may be more influential than financial reporting consequences because of the real effect on cash flow. To the extent that this is true, such conformity could lead to an understatement of earnings for financial reporting as well as tax purposes, resulting in lower taxes and increased cash flow.

Maintaining current tax rules means that, to the extent that a business purchases goodwill or other nonamortizable intangible assets, expense and revenue will not be properly matched. It also means that, as with the second policy alternative, some businesses may receive disparate tax treatment. The economic bias against goodwill and other nonamortizable intangible assets also could have an adverse impact on business pricing and acquisition decisions.

Maintaining current tax rules means accepting the fact that resources will continue to be needed to resolve disputes between IRS and taxpayers over useful life determinations. IRS officials told us that intangible asset amortization issues are among the most frequent issues encountered in doing corporate audits and that IRS will continue to pursue each issue identified. They also said that resolution of the issues identified during their survey of open intangible asset issues (see ch. 3) could require future litigation.

Conclusions

Revising current tax rules could solve many of the problems encountered by taxpayers and IRS concerning the amortization of intangible assets. Current tax rules allow taxpayers discretion in determining whether a purchased intangible asset is amortizable (separable from goodwill), its cost basis, and its useful life. Taxpayers in various industries have claimed billions of dollars in intangible asset amortization deductions based on their own determinations, many of which were subsequently challenged by IRS during audits. Disagreements between taxpayers and IRS may have to be resolved on a case-by-case basis by the courts. The fact and circumstance based nature of the controversy leads to costly disagreements between taxpayers and IRS and can result in inconsistent treatment for similarly situated taxpayers.

These intangible asset amortization problems could be solved by tax rule changes that would allow the amortization of purchased intangible assets, including goodwill, and provide specific cost recovery periods for intangible assets. These changes could result in consistent treatment of all assets on the basis of their contribution to the business by improving taxpayers' ability to match expense with revenue. They could also lessen administrative burden and increase certainty regarding useful life periods for both taxpayers and IRS. The effect of these changes on U.S tax revenue would depend upon the time periods for amortizing the assets.

A change from the current regulatory treatment of goodwill to the use of statutory cost recovery periods for all purchased intangible assets, including goodwill, would raise the issue of the proper tax treatment of costs that create intangible assets. The nonamortization status of goodwill in the 1927 regulations has influenced how taxpayers, IRS, and the courts have treated the cost of creating goodwill. These practices and judicial doctrines may be left in a state of uncertainty if the basic rule is changed. At a minimum, guidance may be needed to assist taxpayers and the IRS on how to treat such costs. Any new rules covering such costs may also affect revenues.

Matters for Congressional Consideration

We believe that Congress should consider revising current tax law to allow amortization of purchased intangible assets, including goodwill, over specific statutory cost recovery periods.

Taxpayer-Claimed Intangible Assets

Accelerated market growth
Access programming
Accounts receivable
Accounts/vendors
Acquisition costs/organization expenses
Advertising lists
Advertising contracts
Agreements
Assembled workforce
Backlog
Bargain leases
Broadcasting rights
Brochures/catalogs
Cable franchises
Capital grants expensed
Competitive advantage
Computer programs
Computer software
Computer software license
Computer software manuals
Concessions and scoreboards
Construction contracts
Construction permit
Consulting agreements
Consumer franchises
Contracts (general)
Contracts with related companies
Copyrights
Core deposits (demand, savings, certificates of deposit, and premium)
Course material
Covenant not to compete
Credit files
Customer base
Customer contracts
Customer lists
Customer relations
Customer routes
Customer structure
Data base
Dealer network
Deferred financing costs
Deferred organization
Delivery system

Deposit base
Development rights
Diminishing network compensation
Disadvantage competition
Distributions
Drawings
Employment agreement contracts
Equipment leases
Equity in unearned premium
Equity on government owned property
Favorable financing/favorable savings
Favorable leases
Favorable wage rates
Federal Communications Commission license
Field staff
Film contracts
Formulas
Franchises (general)
Gas allocation rights
Gas purchase contracts
Income agreement
Information systems
Insurance client list
Insurance contracts
Insurance expirations (lists)
Insurance-in-force
Key employee
Lease rights
Leasehold improvements
Leasehold interests/equity
Leases (general)
Legal and auditing
Library
Licensing agreement (television, cable, radio)
Lists (dealers and others not listed)
Loan portfolio premium
Local media contracts
Location value
Long-term leases
Mailing list
Maintenance contracts
Make-ready costs
Management contracts

Manufacturing agreements
Manufacturing process and procedures
Manufacturing representations
Market service (product support)
Marketing contracts
Medical records
Miscellaneous expenses
Morgue
Mortgage servicing (lists)
Mortgage servicing rights
Negative asset base
Newspaper masters
Nonunion status
Novelty rights
Nurse files
Nurse procedures/manuals
On-air talent contracts
Other advertising relations
Patent application
Patents
Patient files/records
Physician/dental referral
Player contracts
Premium on loan
Premium market population asset
Premium market revenue asset
Premium on early delivery of plant
Premium on investment securities
Prepaid leases
Presold contracts
Product line
Profit and loss revenue
Program format
Proposal contracts
Purchase order contracts
Radio franchises
Rate files/photo files
Real estate option leases
Recipes
Recruitment and financial assets
Research and development
Right to solicit customers
Rights (general)

Safe deposit box contracts
Savings value of escrow fund
Service contracts
Servicing rights
Specialty program contracts
Standstill agreements
Stock of first bank
Student files
Studio space and site leases
Subscription lists
Supply contracts
Technical expertise
Technical manuals
Technician files
Technology
Television franchises
Timber cutting rights
Timber leasehold
Trademarks
Trade names
Trained staff
Training programs
Television network affiliation
Television spots
Underdeveloped market (competition)
Unfilled purchase orders
Unpatented know-how
Value of loans receivable
Vehicles in service
Water rights

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