taxanalysts shelf project

Sale of Goodwill and Other Intangibles as Ordinary Income

By Calvin H. Johnson

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According to Johnson:

This proposal would define gain from the sale of business goodwill and business intangibles as gain from an ordinary asset. Under current law, the costs of achieving future income by creating or improving business goodwill and intangibles is deducted immediately. The proceeds of the sale of the business goodwill and intangibles is capital gain. The combination of deduction of input and capital gain for sales proceeds leads to a strongly negative tax or subsidy. The combination, for instance, can turn a 10 percent pretax return into a 25 percent after-tax return. The subsidy gives taxpayers an incentive to waste capital. The proposal would reduce the subsidy, but only capitalization of the costs of intangibles — not proposed here — can yield some positive tax. Ordinary character would apply to the sale of partnership interests and S corporation shares to the extent of gain attributable to the sale of business intangibles held at the entity level.

The proposal is made as a part of the Shelf Project, which is a collaboration among tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project is found at ''The Shelf Project: Revenue-Raising Proposals That Defend the Tax Base,'' *Tax Notes,* Dec. 10, 2007, p. 1077, *Doc 2007-22632, 2007 TNT 238-37*, and in a letter to the editor, ''A Better, Smarter Tax System Is Not a Partisan Project,'' *Tax Notes*, Jan. 7, 2008, p. 223, *Doc 2007-28320, 2008 TNT 5-30*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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The combination of ordinary deductions for the costs of producing business intangibles and capital gain rates for the product of a sale of business intangibles yields an intensely ''negative tax.'' The negative tax is an off-budget subsidy, which channels capital into inferior investments that would not be undertaken in the absence of tax. To raise the tax rate to *zero* to eliminate the subsidy, gain attributable to the sale of goodwill and other business intangibles needs to be taxed at ordinary rates.

I. Current Law

Businesses incur costs for intangible business assets that will produce income in the future. Sometimes the costs are identified with specifically named intangibles, such as workforce in place, customer base, or startup expenses, but more commonly the costs are just considered costs of the whole business as a going concern. Business goodwill, for instance, is the residual value of a whole company as a going concern that cannot be attributed to what accounting considers to be an asset on the balance sheet. Nonfinancial businesses that do not own a factory — including, for instance, businesses that provide services — commonly have a value that is predominantly goodwill. A living company has high goodwill value because it is able to acquire and process inputs, find customers and distribute product, and hire employees to reproduce itself, and because it will ordinarily make a return from its business processes that is higher than that attributable to the modest tangible assets it may own.

In general, the cost of developing and improving business goodwill and business intangibles is deducted from ordinary income currently. As a matter of economics, the costs of business intangibles are commonly investments because they yield future income. To reflect economic income, investment costs are usually capitalized when made and allowed as deductions only as the costs expire over their useful life. Under regulations finalized in 2003, however, costs of self-development of business intangibles not attached to assets that can be sold separately from the sale of the business as a whole are generally deducted immediately or expensed. Expensed intangible costs include costs of developing the workforce or customer base, advertising, development of

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computer software, salary or wages paid to employees except for inventoried costs, contract rights not protected by property remedies, and package design, as well as costs associated only with general goodwill. Expenditures that do not qualify as expensed intangibles and must be capitalized include the purchase of goodwill or intangibles from another company; the development of assets that could be sold separately (other than computer software); and financial instruments, deposits, or funds. Prepayments of next year's expenses may be deducted this year, even if the expenses are substantial and merely accrued. Reg. section 1.263-4. In allowing deduction of intangibles, tax generally follows nontax accounting. Generally accepted accounting principles for nontax reporting require the expensing of costs that cannot be associated with assets that nontax accounting will recognize as assets, or that give values that are inherent in the continuing business as a whole.[1]

The expensing of business intangibles is related to the expensing of research and experimental costs allowed by section 174 of the code. The expensing of computer software, for example, arose when computers were considered to be highly speculative costs.[2] Before 1954, the courts generally capitalized research and experimental costs,[3] but the IRS testified that it could see no economic advantage to expensing and that it would not challenge consistently applied expensing, and Congress in 1954 codified the IRS concession, even if it was erroneous.[4] Among the other costs with investment value that may be expensed are costs of drilling for oil, development of mines, reforestation of timber, crop planting, and soil conservation and improvement.[5] Operating losses early in a business's life or during a cyclical downturn are also sometimes necessary prerequisites for future income. The decision to allow expensing for intangibles means that the tax law draws no distinction between ordinary business expenses that are worthless by the end of the tax year and costs of investments that produce material future income.

If the company sells the entire business, the sales proceeds must be apportioned among the business assets according to the relative fair market value of the assets.[6] The price paid in excess of the fair market value of the tangible assets of the business is allocated to business intangibles and then goodwill.[7] The amount of the purchase price allocated to the business intangibles and goodwill is considered to be capital gain.[8] If purchasers buy the business by buying shares of an S corporation or the partners' ownership interests, the gain is capital gain to the seller. Section 751 of the code, however, will recharacterize capital gain from the sale of partnership interests as ordinary gain to the extent the gain is attributable to the sale of items that would not be capital gain on the partnership level.

II. Reasons for Change

The ordinary deduction of the costs of creating or improving business intangibles combined with capital gain for the ultimate sale yields a negative tax, whereby the internal rate of return *increases* by reason of tax. By presumption within a free market economy, the pretax profit from an investment measures the value of the investment to real customers that exceeds the real costs. When the tax system imposes positive tax on some investments and negative tax on others, it gives taxpayers an incentive to make wasteful use of precious capital. When Congress acts rationally to subsidize transactions, it does so through the federal budget, because the budget for federal spending is the only competitive mechanism in which the government makes hard cost-benefit decisions. Off-budget subsidies are delivered without application of rational analysis or discipline. Fairness implies that before taxes are raised on some transactions, the tax system should bring negative taxes up to zero.

In the following hypothetical, current law's treatment of the development of goodwill or other business intangibles increases the internal rate of return from the investment from 10 percent to 25 percent! Assume, for example, a taxpayer makes payments of $10 to bear losses or develop business intangibles not associated with any specific balance sheet asset in each of the first three years of ownership of a business. On the sale of the business at the end of the third year, the taxpayer is able to receive $36.41 from the buyer that is not associated with any specific balance sheet asset except the business as a whole.

[1]Accounting Principles Board Opinion No. 17, "Intangible Assets," paras. 11, 24 (1970) (costs of developing intangible assets that are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business as a whole are expensed when incurred); "Accounting for Research and Development Costs," Statement of Financial Accounting Standard No. 2, para. 49 (1974) (requiring the immediate expensing of research and development costs).

[2]*See* Rev. Proc. 69-21, 1969-2 C.B. 303.

[3]*See, e.g., Hart-Bartlett-Sturtevant Grain Co. v. Commissioner*, 182 F.2d 153, 156 (8th Cir. 1950) ("it has been consistently held that experimental and research costs for new processes, formulae or patents are capital expenditures"); Donald Alexander, "Research and Experimental Expenditures Under the 1954 Code," 10 *Tax L. Rev*. 549, 549-552 (1955).

[4]2 General Revenue Revision: Hearings Before the Comm. on Ways and Means, 83d Cong., 1st Sess. 956, 940, 945, 955 (citing the IRS concession). For a criticism of the validity of the consistency argument, see Calvin Johnson, "Soft Money Investing Under the Income Tax," 1989 *Ill. L. Rev*. 1019, 1072-1079.

[5]Section 263(c) (expensing of costs of drilling for oil); section 616 (expensing of the costs of mine development); section 194(b) (deduction of up to $10,000 a year of reforestation expenses); section 175 (soil conservation costs); section 180 (fertilizer and soil improvement costs); reg. section 1.162-12 (1997) (farmer's cost of seed and small plants may be expensed even though crop is to be sold in future years).

[6]*Williams v. McGowan*, 152 F.2d 570 (1945).

[7]Section 1060; reg. section 1.338-6 (vi) and (vii) by reference from reg. section 1.1060-1(a)(1).

[8]*See, e.g., Schmitz v. Commissioner*, 457 F.2d 1022 (9th Cir. 1972).

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Year	0	1	2	3
Gain				36.41
Periodic payment	($10)	($10)	($10)	
Internal rate of return	10%			

The example was created with a 10 percent internal rate of return before tax. Internal rate of return is the interest-like return from the investment itself. If a bank account advertised a 10 percent interest rate compounding annually, then a depositor could put the three $10 payments into that bank account and withdraw the $36.41 at the end of the third year.[9]

Now assume that the periodic payments are deductible in a 35 percent bracket. The after-tax cost of the three early payments are reduced to $10 * (1-35%) or $6.50. Assume, as under current law, that the gain attributable to the goodwill or unattached business intangible qualifies as capital gain. The gain is reduced by 15 percent to $30.95. The internal rate of return from the investment is 25 percent.[10]

Year	0	1	2	3
Gain				30.95
Periodic payment	($6.50)	($6.50)	($6.50)	
Internal rate of return	25%			

In effect, tax law has improved the interest-like return from this investment by 2½ times, from 10 percent to 25 percent. This template of ordinary deduction for the input and capital gain for the output arises commonly in S corporations, partnerships, and investments in business intangibles situations.

A recapture remedy would reduce the negative tax or subsidy, but would not bring the tax up to zero. A recapture remedy would turn the $36.41 capital gain into ordinary income only to the extent of the previously deducted inputs, that is, $10 * 3 or $30. Recapture would allow the remainder of the gain ($6.41) to qualify for capital gain, taxed at 15 percent. Imposing 35 percent tax on $30 and 15 percent tax on $6.41 would reduce the pretax $36.41 to $24.95. After tax, the transaction has an internal rate of return of 13 percent.[11] A subsidy going from 10 percent to 13 percent is not as large as under current law, which carries the transaction from 10 percent to 25 percent, but recapture still allows for a subsidy or negative tax that is 30 percent of the pretax return in the hypothetical.[12]

Capitalization of the costs of business intangibles would prevent the negative tax. Economically, the three $10 costs have not been lost and have not depreciated because the value to the taxpayer allowed by the costs is rising and is higher than the costs at all times. If the three $10 costs were capitalized and used against capital gain from the sale, the investment would yield an 8.6 percent return after tax,[13] which is tantamount to a 14 percent tax on annual internal return. The 2003 Treasury regulations, however, concluded that investments in business intangibles could not be distinguished from expired or lost costs. Under that premise, a positive tax on investments in business intangibles is not possible. The proposal, however, tries to limit the unbudgeted, unjustified subsidy for business intangibles by preventing capital gain produced by uncapitalized costs.

Even if a substantial fraction of the business costs are capitalized, it can still be appropriate to tax gain from the sale of business intangibles at ordinary rates. Assume, in that continuing hypothetical, for example, that one-third of each $10 cost is capitalized and two-thirds of each $10 cost are startup losses or intangibles deducted immediately. Deduction of two-thirds will save $2.33 ($10 * ⅔ * 35%), which will reduce the cost of inputs to $7.67. The one-third of the costs that were capitalized would give a $10 basis that would reduce gain by $10, from $36.41 to $26.41. Taxing the $26.41 gain at ordinary 35 percent rates would reduce the proceeds of the sale by $9.24, from $36.41 to $27.17. Under those circumstances, even the ordinary tax rates reduce the internal rate of return from the transaction by 14 percent.[14] Since Congress tried to impose a tax of 15 percent on capital gains, the 14 percent effective tax rate is not onerous or inconsistent with congressional intent.

Current law's giving capital gain treatment to the product of expensed costs is anomalous within the meaning of capital gain generally. Capital gain is the appreciation due to fluctuation of the taxpayer's capital, including both debt and equity capital within the meaning of capital. But expensed investments have a status identical to business expenses, and there is no capitalization or capital. Without capital, the gain cannot be considered an appreciation of the capital.

There are other factors commonly associated with the sale of business intangibles that indicate that ordinary income is the more appropriate rate. Returns to entrepreneurial skill are labor income, not capital gain. Also, capital gain traditionally has meant amounts allocated to the capital account — that is, to amounts not consumable but rather returned to corpus or capital; sale proceeds from business intangibles are commonly given to the income interest and are consumable. If amounts attributable to entrepreneurial skill, luck, or consumed amounts

[9] $\$10 * (1+10\%)^3 + \$10 * (1+10\%)^2 + \$10 * (1+10\%) = \$36.41$.

[10] $\$6.50 * (1+25\%)^3 + \$6.50 * (1+25\%)^2 + \$6.50 * (1+25\%) = \$30.95$.

[11] $\$6.50 * (1+13\%)^3 + \$6.50 * (1+13\%)^2 + \$6.50 * (1+13\%) = \$24.95$.

[12] If the code recaptures not just the prior deductions, but also a 10 percent return on the prior deductions, the full $36.41 would be ordinary income, which would increase the tax to zero.

[13] $\$10 * (1+8.6\%)^3 + \$10 * (1+8.6\%)^2 + \$10 * (1+8.6\%) = \$35.45$. A tax that reduces interest (internal rate of return) from 10 percent to 8.6 percent has a 14 percent effective tax rate. A 15 percent tax on the gain from $36.41 would reduce pretax $36.41 by 15% * ($36.41-$30), yielding $35.45.

[14] $\$7.67 * (1+8.6\%)^3 + \$7.67 * (1+8.6\%)^3 + \$7.67 * (1+8.6\%) = \$27.17$.

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are made into ordinary income, even though the amounts are not attributable to expensed investments, the result may still be an improvement in the law.

III. Explanation of the Provision

The proposal would amend subsection 1221(a) of the code, adding a new subsection (8) to exclude from capital asset eligibility the following:

(8) Business intangibles.

> (A) Any intangible business assets, as defined by 197(c), including goodwill, the cost of which is not capitalized under section 263 when developed or acquired.
>
> (B) Proceeds of the sale of a business not specifically attributable to an asset the cost of which was capitalized under section 263.
>
> (C) As determined by the Secretary of the Treasury or his delegate, any material asset or transaction, the sale of which would increase the pretax return from the asset or transaction if the asset or transaction were treated as creating a capital gain.
>
> (D) Intangible business assets, as defined by 197(c), and business goodwill, although acquired from another taxpayer.

Paragraph (C) is intended to allow the IRS and the courts to locate transactions with negative tax by reason of capital gains rates and to stop them. Paragraph (C) gives notice to taxpayers not to rely on negative tax transactions arising from the deduction of inputs and capital gain on the returns, no matter how clever.

Paragraph (D) will make even intangibles acquired from another taxpayer into ordinary assets. When a corporation acquires a business intangible from another taxpayer, it will generally be unable to deduct its cost immediately, but will be able to amortize the cost over 15 years. Section 197. It is not, however, feasible to ascertain or enforce a line between gain attributable to capitalized and expensed costs in the business intangibles area. The reason why self-developed intangibles are expensed rather than capitalized and why purchased intangibles are amortized over a short arbitrary life is that neither tax nor nontax accounting is willing to undertake the effort of determining whether costs have expired and are properly deducted, or whether they continue to be income-producing investments in the future, which are properly continued as adjusted basis. Investments in business intangibles are treated by tax and nontax accounting as indistinguishable from general business expenses. When an acquired business or business intangible is assimilated into the acquired business, there is no longer any possibility of separating out gain attributable to the acquired intangibles from gain attributable to general business expenses. Commonly, an acquisition is made to acquire workforce or a talented executive, and the personnel are brought immediately into the existing business. Even if an acquired business is kept intact, it is not possible to prevent infusion of expensed investments that are responsible for subsequent gain. If one were to compare the adjusted basis under section 197 with all of the general business expenses of the business, the section 197 items would almost always be treated as not a material part of the whole.

Because basis in acquired section 197 assets is generally not material in comparison with the general business expenses over the amortization period, and because of the impossibility of allocating between expensed and amortized basis with reasonable accounting, proposed section 1221(a)(8) treats all business intangibles as defined by section 197(c) as ordinary assets in full. Treating all gain from the sale of business assets will simplify the law. It will not lead to relative overtaxation of acquired business intangibles in general, because the 15-year amortization of section 197 is a relatively advantageous tax regime. Indeed, many intangibles are nondepreciating pools refreshed by new business expenses that maintain or improve the intangible. Giving a 15-year amortization schedule to pools that are in fact not expiring reduces the tax rate, under one set of reasonable assumptions, by about half of the statutory tax rate.[15] The denial of capital gains rates to appreciating business intangibles would offset the advantage of 15-year depreciation but not deny the advantage in full.

The proposal would repeal section 1235, which allows capital gain for some sales of patents. Patents are created by expenses deducted under section 174 (research and development costs). The combination of ordinary deduction for the investment in patents and capital gain for their sale leads to an off-budget subsidy that is not justified by rational analysis or discipline. Repeal of section 1235 would not yield positive effective tax rates on the development and sales of patents, but repeal and enactment of section 1221(a)(8) would reduce the negative tax. Patents justified by their underlying nontax merit would not be impeded by the proposal.

When businesses are conducted through passthrough entities — that is, S corporations and tax partnerships (including limited liability companies) — the ordinary deductions pass through to the owner. When and if the sale of the ownership interests produces capital gain, the owner of stock can thus achieve the negative tax under current law, even after adoption of section 1221(a)(8), by selling stock for capital gain rather than selling assets. Under current law, section 751 of the code now turns capital gain on the sale of a partnership interest into ordinary income because the transferring partner receives amounts attributable to assets that would not be capital gain if sold by the partnership. With the adoption of proposed section 1221(a)(8), section 751(d)(2) will make the gain from the sale of the partnership interest attributable to goodwill or business intangibles into ordinary gain. S corporations are also passthrough entities with access to the negative tax arising from ordinary deduction of inputs and capital gain on the outputs. There needs to be a new section 1368A, ''Sales of Stock by S Shareholders,'' that is parallel to section 751 and makes the sale of stock ordinary income for both inventory and

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[15] *See, e.g.*, Calvin Johnson, ''Effective Tax Rates on High-Goodwill Takeovers Under House and Senate Bills,'' *Tax Notes*, July 26, 1993, p. 531, *93 TNT 158-53*.

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business intangibles. On the issue of negative tax from expensing and capital gain combined, an S corporation is indistinguishable from a partnership.

A possibility that has been rejected is relying on new section 1221(a)(8) on the entity level alone and not visiting the ordinary income character on the shareholder or partner level. If all S corporate shareholders and all partners paid tax at a rate at least as high as the selling owner pays, then the entity-level ordinary income on the sales proceeds would be a sufficient remedy. Low- or zero-tax owners, however, can own partnership and S corporation interests. Indeed, an accommodation charity or pension fund can be inserted as an owner to absorb the tax hit from ordinary income. Given the inadequacy of the entity-level remedy alone, it is necessary to recharacterize sales of the shares or partnership interests as ordinary to the extent attributable to goodwill and other intangibles.

As partnerships and S corporations have grown larger, the owners do not always have access to the information about their business's inventory and business intangibles. It is critical, however, to prevent the intense off-budget subsidies arising from the ordinary deduction of inputs and capital gain on returns. A partner or S shareholder should be able to rely on section 751 and new section 1368A if the information is available, but a workable rule is needed that would foreclose abuse thoroughly and that can be applied solely from the taxpayer's own information. It is proposed here that capital gain should not exceed adjusted basis times normal returns on publicly traded stock as determined by the Dow Jones or NASDAQ index. If an S shareholder or partner achieves better than normal returns, then the returns would be attributed to business intangibles acquired by deductible inputs, entrepreneurial labor, or pure luck; and the gain in excess of normal returns would be taxed as ordinary income. The proposal would require the taxpayer to keep track of all basis adjustments and apply what may be a multiyear index to the adjusted basis amounts.

Alternatively for simplicity, gain from the sale of passthrough entities could be taxed as ordinary income. The owner of a passthrough entity who wanted to achieve capital gain in part would have to have a sale of assets by the S corporation or the partnership, because only on the entity level is the information available that would allow more nuanced allocations between capital assets and intangibles.

The sale of stock of a regular or C corporation would not be subject to the new section 751(a) or section 1368A recharacterization as ordinary income. C corporations, by presumption, pay 35 percent taxes on their income. The shareholder-level capital gain tax is in addition to the corporate tax, and the lower rate is justified by a 35 percent corporate tax, when that is paid. Section 1(h)(11), for instance, now gives capital gains rates to dividends, even though dividends were not traditionally capital gain items, to reflect the prior corporate tax. On the corporate level, the expensing of investments in business intangibles means that tax does not reduce the pretax internal rate of return from the investment, but the corporate tax does mean that the effective tax rate is zero, and the shareholder capital gain adds 15 percent to the zero tax.

Treating the gain from the sale of goodwill and other intangibles as ordinary income would simplify the law in that it would get rid of the distinction — which is difficult if not impossible to ascertain even in theory — between receipts for a covenant not to compete and receipts for the sale of goodwill.[16] Receipts for either covenants not to compete or for goodwill would be ordinary income under the proposal.

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[16]*Schulz v. Commissioner*, 294 F.2d 52 (9th Cir. 1961) (questioning the inherent viability of the distinction between goodwill and covenant not to compete); *Barran v. Commissioner*, 334 F.2d 58 (5th Cir. 1964); *Levine v. Commissioner*, 324 F.2d 298 (3d Cir. 1963).

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