Are Allocations Among §197 Assets Important?

By John C. Price, CPA

Prior to the enactment of IRC §197 in 1993, tax professionals paid great detail to identifying and valuing intangible assets with a limited useful life acquired as part of a business acquisition. The reason was clearly to carve acquisition cost out of goodwill, and allocate amounts to intangible assets that could be amortized for tax purposes. In 1991, the GAO estimated that the IRS assessed $8 billion in deficiencies against taxpayers who attempted to amortize intangibles that the IRS claimed were part of non-amortizable goodwill. The current rules led to significant litigation and uncertainty, and prompted Congress to introduce and eventually pass IRC §197.

IRC §197 allows taxpayers an amortization deduction for the capitalized cost of acquiring a §197 intangible. The intangible must be held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. A §197 asset does not include any self-created intangible assets. §197 assets are generally purchased as part of an asset acquisition of a going concern.

§197 assets include the following:

1. Goodwill;
2. Going concern value;
3. Workforce in place;
4. Information base, such as business books and records;
5. Patents, copyrights, know-how and similar items;
6. Customer-based intangible;
7. Supplier-based intangible;
8. Intangibles similar to (3) through (7) above;
9. Licenses and permits granted by governmental units;
10. Covenants not to compete;
11. Franchises, trademarks, and trade names; and
12. Contracts for the use of §197 intangibles.

It seems that post IRC §197, tax professionals have spent much less time identifying and valuing all the various intangible assets purchased in a business acquisition. For GAAP purposes, specific intangibles continue to be identified and valued because there are different rules for expensing different types of intangibles.

Should tax professionals pay more attention to allocating the "blue sky" of an acquisition to all the purchased intangibles, or just treat the excess as goodwill and amortize the amount under IRC §197? From a deduction standpoint, it probably does not matter how the allocation is made. However, on a subsequent disposition (assuming a pass-through entity with individual owners), the allocation can be very important.

An IRC §197 asset is subject to IRC §1245 recapture. At current tax rates, recapture income is taxed at 35 percent while the capital gain rate is only 15 percent.

Therefore, there is a strong argument to identify and allocate amounts to intangibles that have a determinable or limited useful life, and allocate more dollars away from goodwill and going concern. Then, upon a subsequent disposition, you can argue that no proceeds should be allocated to these intangibles because their useful life has expired, and they have no further value.

For example, at acquisition there is some value to having a workforce in place. However, 10 years later at disposition while there is a workforce in place, it's probably not the same workforce that was originally acquired. Thus, there is no purchase price allocation to the acquired workforce, and no IRC §1245 recapture. The workforce in place currently being sold is a new self-created intangible that was never amortized, thus no §1245 recapture. A like argument is made for similar limited-lived intangibles.

Will the Internal Revenue Service challenge their positions? That is uncertain. Have tax professionals become too complacent with respect to §197 asset allocation? That may be the case.

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