

# **PURCHASES OF BUSINESSES WITH GOODWILL AND SIMILAR INTANGIBLES: AN UPDATE ON POSSIBLE STRATEGIES**

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## **ABSTRACT**

For decades leading up to 1993, there were substantial disagreements amongst tax administrators, tax payers, and tax practitioners as to the tax treatment of purchased goodwill and similar intangibles. Internally generated intangibles are generally deductible when incurred. The treatment of the cost of purchased intangibles was unsettled. Some believed they were neither deductible nor amortizable (locked-up as assets until the business was sold or failed). Some others believed they were amortizable? The *Revenue Reconciliation Act of 1993* and Internal Revenue Code § 197 made goodwill and similar intangibles amortizable over 15 years. The amortization deductions were subject to recapture. This research begins the process of investigating the effect of this recapture on negotiations related to the purchase of a business.

## **ANALYSIS**

Section 197 allows one to amortize purchased § 197 intangibles acquired after August 10, 1993 over 15 years. Section 197 intangibles include goodwill and going concern value, plus many other specified technology, company and customer based intangibles. Other examples: workforce in place; books, records, operating systems, and other information bases; patents, copyrights, formulas, processes, designs, etc.; licenses, permits, or other rights granted by a governments; covenants not to compete and similar arrangements; and franchises, trademarks, or trade names. Section 197 does not apply to internally-generated (self-created) intangible assets or purchased computer software. In Private Letter Ruling 200243002 (10/25/2002), the IRS took the position that any § 197 property that was amortized does not qualify as a capital asset since it is subject to amortization/depreciation under § 167. Accordingly, they conclude, the asset is a § 1231 asset. Any amortization allowed with respect to the asset is subject to recapture under § 1245. However, this ruling did not change the effect of prior law on intangibles that are not subject to amortization. Since § 197 specifically does not apply to self-created goodwill and similar intangibles, these assets continue to generally qualify as capital assets as they did under prior law.

The strategies related to the purchase of a business are multi-faceted. Should an acquisition be an asset purchase; or if the seller is incorporated, a stock purchase? Does the price differ from one to the other? And, if it is an asset purchase, how is the purchase price allocated among the assets? This research is limited to asset purchases. Goodwill and similar assets are only recorded for tax purposes in such situations. Initially, § 197 appears to be an easy study—If the cost of a business's assets cannot be assigned to expensable and shorter lived assets, all is not lost--the excess is goodwill (or a similar intangible asset) that can be amortized over 15 years under § 197. But if the assets of the business might be later sold things are a bit more complicated. Basically, recording the goodwill and claiming the amortization, followed by the recapture, is still a positive since taxes are deferred. But, is there a better potential outcome? If greater creativity at the time of purchase can avoid recapture, the result is even greater. It may be possible to accomplish deferral plus conversion—ordinary deductions now, § 1231 gain later.