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Purchase Price Allocation Rules: Sections 1060, 338, and 197

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PURCHASE PRICE ALLOCATION RULES: SECTIONS 1060, 338, AND 197

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PART ONE: INTRODUCTION

I. INTRODUCTION

A. One of the most publicized and long-awaited business provisions contained in the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, 107 Stat. 312 (1993) (the "1993 Act") was section 197 of the Internal Revenue Code of 1986 (the "Code"), which governs the tax treatment of acquired intangible assets.

B. However, section 197 cannot be analyzed in isolation. Since it comes into play whenever there is an allocation of consideration to an amortizable section 197 intangible, a basic understanding of the allocation rules of sections 1060 and 338(h)(10) is critical.

C. Thus, PART ONE of this Outline summarizes the allocation provisions of sections 1060 and 338(h)(10). PART TWO of this Outline contains introductory material relating to section 197, describes the statutory regime and the regulations, and illustrates through examples the application of section 197 in various acquisition transactions.

II. SECTION 1060: SPECIAL ALLOCATION RULES FOR CERTAIN ASSET ACQUISITIONS

A. The Need For Allocation

1. The purchase and sale of an ongoing business involves, of course, the purchase and sale of numerous separate items, often including intangibles such as goodwill and/or the agreement of the seller not to compete with the purchaser for a period of time.

2. Historically, goodwill was treated as a nondepreciable, capital asset. A seller often has no basis in any goodwill associated with its business.

3. In contrast, tangible assets (other than land and inventory) generally consist of depreciable property described in section 1231.

4. Amounts received in exchange for a covenant not to compete were typically amortizable by the purchaser over the period for which the covenant ran, and were ordinary income to the seller to the full extent of the payments.

B. Competing Interests

1. Prior to the Tax Reform Act of 1986 (the "1986 Act"), purchasers and sellers generally had competing interests with regard to the allocation of consideration in the sale of a business.

2. A purchaser generally wished to allocate as much consideration as possible to assets with short depreciable or amortizable lives. Accordingly, given a choice between allocating consideration to goodwill or to a covenant not to compete, the purchaser would generally prefer an allocation to the covenant.

3. In contrast, the seller wished to take advantage of lower capital gains rates. Thus, the seller would generally prefer allocations to goodwill, a capital asset, to allocations to a covenant not to compete, which gives rise to ordinary income.

4. To the extent that any of the transferred assets had comparatively short depreciable lives, the parties might be able to agree on an allocation of additional purchase price to such assets. However, such an allocation could possibly increase recapture income under section 1245 and thus result in ordinary income which the seller would seek to avoid.

C. Litigation Over Purchase Price Allocations

1. Prior to the enactment of section 1060 as part of the 1986 Act, taxpayers and the government had frequently skirmished over purchase price allocations.

   a. Selling taxpayers sought to disregard allocations made to covenants not to compete, and purchasing taxpayers sought to allocate additional amounts to such covenants and away from goodwill.

   b. In cases where the contract of purchase and sale was silent as to the allocation of purchase price, it was possible for the parties to "whipsaw" the government by taking positions inconsistent with each other, but without invoking any elevated burden of proof in the courts.

2. Courts were, in general, reluctant to allow taxpayers to disregard the allocations made in a contract of purchase and sale.

a. Most courts required a taxpayer to provide "strong proof" of the parties' intent of a different allocation than the one contained in the contract in order to disregard the written terms. See, e.g., Kreider v. Commissioner, 762 F.2d 580 (7th Cir. 1985).

b. Some courts went further and adopted a test whereby the taxpayer could disregard allocations in the contract of purchase and sale only by adducing proof which would be admissible under state law to alter the construction of the contract or to show its unenforceability because of mistake, undue influence, fraud, duress, etc. Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967).

c. Substantial litigation also ensued where the contracts were silent as to the allocation of purchase price among the tangible and intangible assets transferred.

(1) Taxpayers often attempted to use the "second tier allocation" method, while the government would usually argue for the "residual method." See, e.g., Barnes Group Inc. v. United States, 697 F. Supp. 591 (D. Conn. 1988); Banc One Corp. v. Commissioner, 84 T.C. 476 (1985) (second tier allocation method rejected in favor of the residual method). But see Rev. Rul. 77-456, 1977-2 C.B. 102 (second tier allocation method used for additional basis attributable to transaction costs).

(a) Under the second tier allocation method, any consideration in excess of the appraised fair market value of all acquired assets, including goodwill, is allocated among the assets (other than cash) in proportion to such appraised fair market value.

(b) Under the residual method, any consideration in excess of the fair market value of separately identifiable assets is allocated solely to goodwill.

(2) The second tier allocation method generally made it easier to allocate less consideration to goodwill and more to depreciable or amortizable assets.

D. The 1986 Act

1. Congress believed in 1986 that the government lacked sufficient resources to challenge effectively cases in which the parties misstated the value of assets when making allocations in connection with the sale of a business. H.R. Conf. Rep. No. 99-841, pt. II, at 208 (1986).

a. Note that as part of the 1986 Act, the differential between capital gains rates and ordinary income rates was eliminated, so that the parties would no longer have substantial competing interests in making purchase price allocations.

b. The purchaser would continue to benefit from allocations to depreciable and/or amortizable property, and the seller would have no incentive to resist such allocations.

2. Congress decided to adopt the residual method already provided for in regulations under section 338, in order to ensure that the value of the business in excess of the value of tangible assets was allocated to goodwill or some similar intangible, rather than to tangible assets with short depreciable lives. Adopting this method also equalized the treatment of asset acquisitions and qualified stock purchases under section 338.

E. Summary of Section 1060

1. Section 1060 applies to any "applicable asset acquisition." Section 1060(a).

a. An applicable asset acquisition is any transfer of assets constituting a trade or business if the purchaser's basis in the acquired assets is determined wholly by reference to the consideration paid for such assets. Section 1060(c).

b. Regulations broadly define "assets constituting a trade or business" as consisting of any group of assets (i) the use of which would constitute an active trade or business for purposes of section 355, or (ii) to which goodwill or going concern value could under any circumstances attach. Treas. Reg. § 1.1060-1(b)(2)(i).

(1) Concurrent with the enactment of section 197 (discussed in greater detail below), references to "goodwill or going concern value" that were contained in section 1060(b) and (d) were changed to "section 197 intangibles."

c. Determination of whether goodwill or going concern value could attach: The Temporary and Final Regulations Effective for Asset Acquisitions on or After January 6, 2000

(1) Temporary regulations providing rules for determining whether goodwill or going concern value can attach to a group of assets under section 1060 were released on January 5, 2000, effective for asset acquisitions on or after January 6, 2000. These regulations were finalized on February 13, 2001, without substantial modification and are effective for asset acquisitions on or after March 16, 2001.

(2) NOTE: Because the language of the final regulations generally mirrors that of the temporary regulations, unless otherwise noted, all references below to the final regulations, effective for asset acquisitions on or after March 16, 2001, include references to the temporary regulations, effective for asset acquisitions on or after January 6, 2000, and before March 16, 2001.

(3) Under the final regulations, goodwill is defined as "the value of a trade or business attributable to the expectancy of continued customer patronage." Treas. Reg. § 1.1060-1(b)(2)(ii). Going concern value is defined as "the additional value that attaches to property because of its existence as an integral part of an ongoing business activity." Id.

(4) In determining whether goodwill or going concern value could attach, all facts and circumstances are taken into account. Treas. Reg. § 1.1060-1(b)(2)(iii). Factors to be considered include:

(a) The presence of any intangible asset, provided the transfer of solely such intangible asset would not constitute a trade or business;

(b) The existence of an excess of the total consideration over the aggregate book value of the tangible and intangible assets purchased (other than goodwill and going concern value) as shown on the books of the purchaser; and

(c) Related transactions, including lease agreements, licenses and other similar arrangements between the purchaser and seller in connection with the transfer.

(5) In listing these factors, the final regulations differ from the old temporary regulations in two respects:

(a) The old temporary regulations did not include the first factor (i.e., the presence of an intangible asset); and

(b) The old temporary regulations included covenants not to compete, employment contracts, and management contracts within related transactions. See Temp. Treas. Reg. § 1.1060-1T(b)(2) (effective prior to January 6, 2000).

(6) QUERY: Does the removal of covenants not to compete, employment contracts, and management contracts from related transactions indicate that such agreements are not factors to be considered in determining whether goodwill or going concern value could attach? Presumably, under the first factor of the final regulations, covenants not to compete should be considered intangible assets, the transfer of which would not be a trade or business in the absence of other assets. Either way, the new regulations provide that a covenant not to compete entered into in connection with an applicable asset acquisition is treated as an asset transferred as part of a trade or business. Treas. Reg. § 1.1060-1(b)(7). Thus, a covenant not to compete must be included in the asset pool when applying the residual method.

2. If section 1060 applies to a transaction, the "consideration received" for the acquired assets must be allocated among the assets in accordance with regulations under section 338(b)(5). Section 1060(a). See also Treas. Reg. § 1.1060-1(c)(2).

a. The regulations require that the consideration be allocated among the assets under the "residual method."

b. On August 4, 1999, the Internal Revenue Service ("Service") issued proposed regulations under section 338. On January 6, 2000, the Service issued temporary regulations that mirrored the proposed regulations. These temporary regulations were finalized with minor modification on February 13, 2001, and are effective for deemed and actual asset acquisitions on or after March 16, 2001. The temporary and final regulations include seven asset classes, defined as follows:

(1) Class I assets consist of cash and general deposit accounts.

(2) Class II assets consist of certificates of deposits, U.S. government securities, readily marketable stock and securities, and foreign currency.

(a) Under the final regulations, Class II assets do not include stock of target affiliates, whether or not of a class that is actively traded, other than actively traded stock defined in section 1504(a)(4).

(b) NOTE: The temporary regulations permitted stock of target affiliates to qualify as Class II assets.

(c) Therefore, Class II assets include stock of target affiliates for asset acquisitions occurring on or after

January 6, 2000, and before March 16, 2001, but do not include stock of target affiliates for asset acquisitions occurring on or after March 16, 2001.

(3) Class III assets consist of accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business.

(4) Class IV assets consist of stock in trade of the taxpayer or other property of a kind which would be included in the inventory of the taxpayer, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

(5) Class V assets consist of all assets other than Class I, II, III, IV, VI, VII assets.

(6) Class VI assets consist of all section 197 intangibles, as defined by section 197, except goodwill and going concern value.

(7) Class VII assets consist of goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible). Treas. Reg. § 1.338-6(b).

(8) These regulations are generally effective for allocation of consideration in asset acquisitions on or after January 6, 2000.

c. Prior to January 6, 2000, consideration was allocated first to "Class I assets," next to "Class II assets" up to their fair market value (and in proportion to their fair market value, if the total consideration is less than their fair market value), then to "Class III assets" up to their fair market value (and in proportion to their fair market value, if the total consideration is less than their fair market value), then to "Class IV assets" up to their fair market value (and in proportion to their fair market value, if the total consideration is less than their fair market value), and finally to "Class V assets." Temp. Treas. Reg. § 1.338(b)-2T(b)(2) (effective prior to January 6, 2000); Temp. Treas. Reg. § 1.1060-1T(d)(2) (effective prior to January 6, 2000). See T.D. 8711 (Jan. 16, 1997) (adding a new "Class V").

(1) These five asset classes were as follows:

(a) Class I assets consist of cash and demand deposits.

(b) Class II assets consist of certificates of deposits, U.S. government securities, readily marketable stock and securities, and foreign currency.

(c) Class III assets consist of tangible and intangible assets other than those described in Classes I, II, IV, and V.

(d) Class IV assets consist of all section 197 intangibles (whether amortizable or not), "except those in the nature of goodwill and going concern value."

(e) Class V assets consist of section 197 intangibles in the nature of goodwill and going concern value. See T.D. 8711 (Jan. 16, 1997). The sum of the amounts allocated to Classes IV and V are reported in the aggregate on Form 8594. See Appendix A; see also T.D. 8711 (Jan. 16, 1997), amending Temp. Treas. Reg. § 1.1060-1T(h)(3).

(2) On January 16, 1997, the Service issued T.D. 8711, which amended Temp. Treas. Reg. §§ 1.1060-1T(d)(2) and 1.338(b)-2T(b) to provide for the five asset classes above.

(a) Prior to the amendment, there was no Class V asset category, and Class IV consisted of intangible assets "in the nature of goodwill and going concern value."

(b) The amendment is effective for applicable asset acquisitions under section 1060 completed on or after February 14, 1997 (and for acquisition dates, as defined in section 338(h)(2), on or after the same date).

(c) The effective date provisions of T.D. 8711 also provide that a taxpayer may elect which rules to apply to transactions entered into prior to February 14, 1997. For acquisition dates prior to February 14, 1997, if section 197 applies to any asset acquired, the taxpayer may consistently (in all transactions in which adjusted grossed-up basis ("AGUB"), aggregate deemed sales price ("ADSP"), modified aggregate deemed sales price ("MADSP"), or consideration must be allocated under section 338 or 1060): (i) apply the new rules; (ii) apply the rules in effect prior to the issuance

T.D. 8711; or (iii) apply the rules in effect prior to the issuance of T.D. 8711, but treat all section 197 intangibles as Class IV assets.

(d) QUERY: If a taxpayer must apply one of these three options "consistently," can the taxpayer choose to apply the new rules for a transaction with an acquisition date prior to February 14, 1997, if such taxpayer had already applied the rules prior to the issuance of T.D. 8711 to an earlier transaction?

i) For example, assume that Taxpayer enters into two transactions, one in 1994 and one in 1996. Taxpayer applied the rules in effect prior to the issuance of T.D. 8711 to the 1994 transaction on its 1994 tax returns.

ii) Under the effective date provisions, it seems that Taxpayer will not be allowed to elect to use the new rules for the 1996 transaction, unless Taxpayer amends its 1994 returns and applies the new rules to the 1994 transaction.

d. NOTE: As stated above, the statutory language refers to the consideration received. The old section 1060 regulations provided, “The purchaser’s consideration is the cost of the assets acquired in the applicable asset acquisition. The seller’s consideration is the amount realized from the applicable asset acquisition under section 1001(b).” Temp. Treas. Reg. § 1.1060-1T(c)(1) (effective prior to January 6, 2000). The final section 1060 regulations slightly amended the definition of consideration to provide, "The seller’s consideration is the amount, in the aggregate, realized from selling the assets in the applicable asset acquisition under section 1001(b). The purchaser’s consideration is the amount, in the aggregate, of its cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis.” Treas. Reg. § 1.1060-1(c)(1).

(1) The regulation appears to be at odds with section 1060(a), which implies that a single amount is to be used for purposes of determining both the transferee's basis and the transferor's gain on the sale.

(2) As illustrated in the examples in this Outline, this distinction raises a number of questions with respect to (i)

the treatment of acquisition costs, and (ii) bargain purchase acquisitions.

(3) With respect to acquisition costs, on December 19, 2002, the Service issued a Notice of Proposed Rulemaking, Reg. 125638-1 (December 19, 2002), proposing regulations (the "Proposed section 263(a) Regulations") that provide rules for determining the extent to which taxpayers must capitalize costs incurred (i) to acquire, create, or enhance intangible assets, (ii) to facilitate the acquisition, creation, or enhancement of intangible assets, and (iii) to facilitate certain restructurings, reorganizations, and transactions involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization. Prop. Treas. Reg. § 1.263(a)-4. Final regulations under section 263(a) were adopted December 31, 2003. T.D. 9107

(a) While providing some guidance regarding the treatment of acquisition costs in applicable asset acquisitions, these regulations fall short of clarifying the issue.

(b) The section 263(a) regulations are discussed in detail in **Example 4** (below).

3. Regulations on the treatment of certain nuclear decommissioning funds for proposes of allocating purchase price in certain deemed and actual asset acquisitions. See Temp. Treas. Reg. §§ 1.338-6T, 1.1060-1T.

a. Background -- Incident to the sale of a nuclear power station, the assets transferred include, *inter alia*, one or more funds set aside to satisfy the owner's responsibility to decommission the nuclear power station after the end of its useful life ("decommissioning liability"). One or more of these funds may be qualified funds as described in section 468B (Special Rules for Designated Settlement Funds). The qualified fund, not its contributor, is considered the owner of the assets in the funds and is, accordingly, taxed thereon. In an actual or deemed sale of a corporation that owns a nuclear power plant, the qualified funds are not treated as sold or purchased. However, one or more funds may be funds not described in section 468B (unqualified funds), which continue to be treated as assets of the contributor. Because the decommissioning liability does not satisfy the economic performance test until decommissioning occurs, it is not included in the purchase price allocated to acquired assets. Thus, the purchase price to be allocated among the assets may be significantly less than the FMV of those assets. Under the residual

method, see Treas. Reg. § 1.338-6, the purchase price is allocated to the nonqualified fund's assets which are typically Class II assets, before being allocated to the plant and equipment (Class V) assets. Because the purchase price does not reflect the decommissioning liability and is first allocated to the nonqualified fund's assets, the purchase price allocated to the plant and equipment assets may be less than their FMV. Accordingly, the taxpayer will not recover a tax benefit until economic performance occurs on decommissioning.

b. Regulations -- To mitigate the tax effect of the decommissioning liability not satisfying the requirements of the economic performance test, the Service promulgated regulations. See Treas. Reg. §§ 1.338-6, 1.1060-1. Those regulations provide that with respect to allocating the purchase price among acquired assets, the taxpayer may elect to treat a nonqualified fund as if it were an entity classified as a corporation, the stock of which is a Class V asset of the target. The hypothetical corporation will be deemed responsible for the decommissioning liability. The regulations convert the nonqualified fund from primarily Class I and II assets to assets of a corporation, the stock of which is a Class V asset, allowing the present cost of the decommissioning liability funded by the unqualified fund to be netted against such fund assets for the sole purpose of valuing the stock of the hypothetical subsidiary. The election is available for asset acquisitions and qualified stock purchases on or after September 1, 2007. Temporary Regulations similar to the Final Regulations apply to asset acquisitions and qualified stock purchases before September 1, 2007 and on or after September 14, 2004. See Temp. Treas. Reg. §§ 1.338-6T, 1.1060-1T.

III. SECTION 338 - TREATING A STOCK PURCHASE AS AN ASSET ACQUISITION

A. Overview

1. If a purchasing corporation acquires 80 percent or more of the stock of the target corporation in a qualified stock purchase ("QSP"), a section 338 election may be made to treat the stock purchase as an asset purchase. Such election must be made within eight and one-half months after the month in which the acquisition date occurs.[1]

[1] Under certain circumstances, step transaction principles may apply where a purchasing corporation acquires 80 percent or more of the stock of the target corporation pursuant to an integrated plan of multiple transactions that, when stepped together, qualifies as a tax-free reorganization under section 368(a). Rev. Rul. 2001-46, I.R.B. 2001-42. In such event, the taxpayer will not be permitted to make a section 338 election because the stock of the target

2. Absent such an election, the purchasing corporation will ordinarily take a carryover basis in the target's assets.

3. If the target corporation was a member of an affiliated group prior to the QSP, the parties may elect under section 338(h)(10) to treat the asset purchase as occurring while target is still a member of such group.

4. Except as otherwise noted, in all discussions of section 338 contained in this Outline, P will represent the purchasing corporation, T will represent the target corporation, and, unless otherwise indicated, it should be assumed that P acquires 100 percent of the stock of T by purchase on the acquisition date.

B. Purchase Price In Deemed Sale Transaction

In the case of a section 338(h)(10) transaction, T's basis in its assets following the transaction is its "adjusted grossed-up basis" ("AGUB") determined pursuant to Treas. Reg. § 1.338(h)(10)-1(d)(2) (effective for deemed asset acquisitions on or after March 16, 2001). See Temp. Treas. Reg. § 1.338(h)(10)-1T(d)(2) (effective for deemed asset acquisitions on or after January 6, 2000 and before March 16, 2001). See Treas. Reg. § 1.338(h)(10)-1(e)(5) (effective for deemed assets acquisitions prior to January 6, 2000).

1. Temporary Regulations (Effective for Deemed Assets Acquisitions on or after January 6, 2000 and before March 16, 2001) and Final Regulations (Effective for Deemed Asset Acquisitions on or after March 16, 2001)

a. AGUB defined

Under the temporary and final regulations, AGUB is the sum of

(1) P’s grossed-up basis in recently purchased T stock;

(2) P’s basis in nonrecently purchased T stock; and

(3) new T’s liabilities. Treas. Reg. § 1.338-5(b)(1).

b. Grossed-up basis in recently purchased T stock

P’s grossed-up basis in recently purchased T stock equals

(1) P’s basis in recently purchased T stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs;

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corporation will have been acquired in an exchange to which sections 354 and 356 applies. See I.R.C. § 338(h)(3)(A)(ii).

(2) multiplied by a fraction, the numerator of which is 100 percent minus the percentage of T stock (by value, determined on the acquisition date) attributable to P's nonrecently purchased T stock, and the denominator of which is the percentage of T stock (by value, determined on the acquisition date) attributable to P's recently purchased T stock;

(3) plus the acquisition costs P incurred in connection with its purchase of the recently purchased stock that are capitalized in the basis of such stock (e.g., brokerage commissions and any similar costs incurred by P to acquire the stock). Treas. Reg. § 1.338-5(c).

(a) NOTE: On December 19, 2002, the Service issued a Notice of Proposed Rulemaking, Reg. 125638-1 (December 19, 2002), proposing regulations that provide rules for determining the extent to which taxpayers must capitalize transaction costs incurred with respect to the acquisition, creation, and enhancement of intangible assets. These proposed regulations are discussed in greater in **Example 4** (below).

c. Basis in nonrecently purchased stock

(1) In the absence of a gain recognition election, P retains its basis in the nonrecently purchased T stock. Treas. Reg. § 1.338-5(d)(1).

(2) If a gain recognition election is made, P is treated as having sold its nonrecently purchased T stock for the basis amount (described below), and its basis on the acquisition date in nonrecently purchased T stock is the basis amount (described below). Treas. Reg. § 1.338-5(d)(3)(i).

(3) Basis amount: The basis amount is P's basis in recently purchased T stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs multiplied by a fraction the numerator of which is the percentage of T stock (by value, determined on the acquisition date) attributable to P's nonrecently purchased T stock and the denominator of which is 100 percent minus the numerator amount. Treas. Reg. § 1.338-5(d)(3)(ii).

d. Liabilities

(1) The liabilities of old T are the liabilities of T that are properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included the discharge of liabilities. Such liabilities may include liabilities for the tax consequences resulting from the deemed sale. The liabilities of old T are measured as of the beginning of the day after the acquisition date. Treas. Reg. § 1.338-4T(d)(1).

(2) NOTE: The definition of liabilities in the final regulations, effective for deemed asset acquisitions on or after March 16, 2001, differs from the definition of liabilities in the temporary regulations, effective for deemed assets acquisitions on or after January 6, 2000, but before March 16, 2001, in two respects:

(a) The temporary regulations provide that the liabilities of old T are the liabilities of T (and the liabilities to which T's assets are subject) as of the beginning of the day after the acquisition date. The purpose for the language change in the final regulations was to simplify the discussion of liabilities and to clarify that the treatment of tax liability is to be determined under general principals of taxation. <u>See</u> Preamble to T.D. 8940 (Feb. 12, 2001).

(b) The final regulations make reference to Treas. Reg. § 1.338-1(d), which applies a next day rule to section 338 transactions. Commentators believed that under the language of the temporary regulations a purchaser acquiring stock of a subsidiary member in a consolidated group could, after acquiring the target stock, cause the target to sell all of its assets to another person later on the closing date and make a unilateral section 338(g) election causing the results of the sale to fall onto the selling consolidated group's return. <u>See</u> Preamble to T.D. 8940 (Feb. 12, 2001). The next day rule is intended to ensure that all tax liability stemming from a post acquisition sale of acquired assets falls on the acquiring corporation by providing that the target and all persons related thereto must treat a post acquisition sale of assets as occurring at the beginning of the day following the transaction and

after the deemed purchase of new target. See Treas. Reg. § 1.338-1(d).

e. Allocation

AGUB is allocated among T's assets pursuant to the residual method under Treas. Reg. § 1.338-6 and –7. See Treas. Reg. § 1.338(h)(10)-1(d)(2).

2. Regulations in Effect Prior to January 6, 2000

a. AGUB defined

Under the regulations in effect prior to January 6, 2000, the AGUB is defined as the sum of

(1) P's grossed-up basis in recently purchased T stock;

(2) P's basis in nonrecently purchased T stock;

(3) new T's liabilities; and

(4) other relevant items. Treas. Reg. § 1.338(b)-1(c)(1) (effective prior to January 6, 2000).

b. Liabilities

Under section 338(b)(2), liabilities of the target are included in the basis of its assets as adjusted under section 338. Thus, to determine the deemed purchase price, the grossed-up basis figure must be adjusted for "liabilities of the target corporation."

(1) Liabilities of the new target include its liabilities and liabilities to which its assets are subject as of the beginning of the day after the acquisition date. Treas. Reg. § 1.338(b)-1(f) (effective prior to January 6, 2000).

(2) In order to be included in P's AGUB as of the beginning of the day after the acquisition date, the liability must be a bona fide liability of T that would otherwise be includible in basis as of that date "under principles of tax law" applicable to asset acquisitions in general. Treas. Reg. § 1.338(b)-1(f)(2)(i) (effective prior to January 6, 2000).

c. Other relevant items

In defining what constitutes "other relevant items," the regulations in effect prior to January 6, 2000, provide that "other relevant

items do not include reductions for acquisition costs incurred by the purchasing corporation in connection with the qualified stock purchase that are capitalized in the basis of recently purchased target stock." Treas. Reg. § 1.338(b)-1(g)(1) (effective prior to January 6, 2000).

C. Determination Of Deemed Sales Price – ADSP and MADSP

1. Temporary Regulations (Effective for Deemed Asset Acquisitions on or after January 6, 2000 and before March 16, 2001) and Final Regulations (Effective for Deemed Asset Acquisitions on or after March 16, 2001)

In the case of a section 338(h)(10) transaction, Treas. Reg. § 1.338(h)(10)-1(d)(3) provides that the deemed sale price of each asset is calculated by determining the "aggregate deemed sales price" ("ADSP") under Treas. Reg. § 1.338-4 and then allocating the ADSP among T's assets in accordance with Treas. Reg. § 1.338-6 and –7. NOTE: The final regulations (effective for deemed assets acquisitions on or after March 16, 2001) differ from the temporary regulations (effective for deemed assets acquisitions on or after January 6, 2000 and before March 16, 2001) only to the extent that the final regulations provide for the redetermination of ADSP when the total payments under an installment obligation are greater or less than the amount realized. See Treas. Reg. § 1.338(h)(10)-1(d)(8)(i).

a. ADSP defined

The ADSP is defined as the sum of

(1) the grossed-up amount realized on the sale to P of P's recently purchased T stock (as defined in section 338(b)(6)(A)); and

(2) old T's liabilities. Treas. Reg. § 1.338-4(b).

b. Grossed-up amount realized on the sale to P of P's recently purchased T stock

The grossed-up amount realized on the sale to P of P's recently purchased T stock is equal to

(1) the amount realized on the sale to P of P's recently purchased T stock determined as if old T were the selling shareholder and the installment method were not available and determined without regard to the selling costs;

(2) divided by the percentage of T stock (by value, determined on the acquisition date) attributable to that recently purchased T stock;

(3) less the selling costs incurred by the selling shareholders in connection with the sale to P of P's recently purchased T stock that reduce their amount realized on the sale of the stock (e.g., brokerage commissions and any similar costs to sell the stock). Treas. Reg. § 1.338-4(c)(1).

c. Liabilities of Old T

(1) The liabilities of old T are the liabilities of T that are properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included the discharge of liabilities. Such liabilities may include liabilities for the tax consequences resulting from the deemed sale. The liabilities of old T are measured as of the beginning of the day after the acquisition date. Treas. Reg. § 1.338-4(d)(1).

(2) NOTE: The definition of liabilities in the final regulations differs from the definition of liabilities in the temporary regulations in the same two respects as under AGUB. See supra Part III.B.1.d.

2. Regulations in Effect Prior to January 6, 2000

In the case of a section 338(h)(10) transaction, Treas. Reg. § 1.338(h)(10)-1(f)(1) (effective prior to January 6, 2000) provides that the deemed sale price of each asset is calculated by determining the "modified aggregate deemed sales price" ("MADSP") and then allocating the MADSP among T's assets in accordance with Treas. Reg. § 1.338(b)-2T (effective prior to January 6, 2000). The MADSP is thus allocated among the assets being sold in accordance with the residual method. See Temp Treas. Reg. § 1.338(b)-2T (effective prior to January 6, 2000).

a. MADSP defined

Like AGUB, the MADSP is defined as the sum of

(1) P's grossed-up basis in recently purchased T stock;

(2) new T's liabilities; and

(3) other relevant items. Treas. Reg. § 1.338(h)(10)-1(f)(2) (effective prior to January 6, 2000).

b. Other relevant items

However, unlike in the definition of AGUB, in defining what constitutes "other relevant items" for purposes of MADSP, the regulations provide that such phrase includes reductions for:

“Acquisition costs of P incurred in connection with the qualified stock purchase that are capitalized in the basis of recently purchased T stock . . . and . . . [s]elling costs of the selling consolidated group . . . that reduce the amount realized on the sale of recently purchased T stock." Treas. Reg. § 1.338(h)(10)-1(f)(4) (effective prior to January 6, 2000); see also Treas. Reg. § 1.338(b)-1(g)(1) (effective prior to January 6, 2000).

IV. REPORTING REQUIREMENTS

A. Overview

1. In general, the parties to an acquisition transaction are not obligated to agree on (i) the valuation of the assets being transferred, or (ii) an allocation of the consideration among the assets being transferred.

2. Thus, for example, if two parties exchange non like-kind property, each party is free to independently determine its amount realized on the transaction and allocate the consideration received among the transferred assets.

3. However, if the transaction is an applicable asset acquisition, each party must satisfy certain reporting requirements. Section 1060 also imposes certain reporting requirements with respect to specific transactions that are not applicable asset acquisitions. These rules are discussed in section IV.B (below).

4. As with section 1060, section 338 also imposes reporting requirements with respect to section 338 transactions. These rules are discussed in section IV.C (below).

5. Also, temporary regulations under section 6043(c) may require parties to both applicable assets acquisitions and section 338 transactions to comply with additional reporting requirements. These rules are discussed in section IV.D (below).

B. Reporting Requirements Under Section 1060

1. Form 8594

The parties to an applicable asset acquisition are each required to file an information statement (on Form 8594, which is attached as Appendix A):

a. Who Must File

(1) Both the purchaser and seller are required to file Form 8594.

(2) The Form 8594 must be attached to each filer's timely filed Federal income tax return.

(3) Note: Taxpayers are not required to file Form 8594 if, pursuant to section 1031, the assets of a trade or business are exchanged for the assets of another trade or business.

b. When and Where to File

(1) The seller and purchaser must file Form 8594 as an attachment to their respective income tax return for the year in which the sale date occurred.

(2) If any amount allocated to an asset is either increased or decreased in a subsequent year, the seller and/or purchaser (whoever is effected by the increase or decrease) must complete Parts I and III of Form 8594 and attach the Form to the income tax return for the year in which the increase or decrease is taken into account.

c. Required Information

Form 8594 requires the following information:

(1) The name, address, and taxpayer identification number of the seller and the purchaser, and the date of the sale/purchase.

(2) The total amount of consideration for the assets.

(3) The actual amount of Class I assets, and the aggregate fair market value of the assets included in each of Class II, III, IV, V, and VI and VII; Class VI and VII are grouped together on Form 8594.

(4) The sum of the aggregate fair market values of all of the Class I - VII assets.

(5) The amount of the sales price allocated to each asset Class (i.e., Class I - VI and VII).

(6) Whether the allocation of purchase price was provided for in a sales contract or other written document signed by both

parties; if the answer is yes, whether the aggregate fair market values for each asset class as listed on Form 8594 are same as the amounts agreed upon in the sales contract or other written document.

(7) Whether there is a related covenant not to compete, employment or management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller); if so, the parties must attach a schedule specifying the type of agreement and the maximum consideration (exclusive of interest) to be paid pursuant to such agreement.

d. NOTE: Form 8594 was updated in 2002 to reflect all seven asset classes present in the final regulations; the previous Form 8594 designated only five asset classes. A copy of the revised form, updated in 2006, and related instructions are attached to this Outline as Appendix A.

e. The enactment of section 197 raises a number of issues pertaining to the proper reporting of asset acquisitions under section 1060. These issues are discussed more fully in **example (2)** of this Outline.

2. Other Specified Transactions

The reporting requirements also apply to certain transactions that ordinarily are not applicable asset acquisitions. These transactions include:

a. A distribution of partnership property or a transfer of a partnership interest where section 755 applies (section 1060(d)(2)); and

b. A transfer by a 10-percent (by value) owner of an entity of any interest in such entity if, in connection with the transfer, the owner (or a related person) enters into an employment contract, covenant not to compete, royalty or lease agreement, or other agreement with the transferee (section 1060(e)(1)); the information to be provided in a section 1060(e) transaction is to be set forth in regulations, which have yet to be issued.

3. Applicable Penalties

a. The return required to be filed under section 1060(b) or (e) is considered an information return, so the failure to file the information return may result in the imposition of a significant penalty under section 6721. Section 6724(d)(1)(B)(xi).

b. If the failure to file is due to "an intentional disregard of the filing requirement," the amount of the penalty can equal as much as "10 percent of the aggregate amount of the items required to be reported correctly." Section 6721(e)(2).

c. However, the penalty is not imposed if it is shown that the failure is due to reasonable cause and not to willful neglect. Section 6724(a).

4. Special Rule for Written Allocation Agreements

a. In 1990, section 1060(a) was amended to provide that if the buyer and seller agree in writing upon the allocation of consideration (or upon the fair market value of any of the assets), such agreement would be binding upon both the buyer and the seller, unless the Service determines that such allocation is not appropriate.

b. The amendment to section 1060(a) was intended to codify the Danielson rule. See H.R. Conf. Rep. No. 101-964, at 1096 (1990).

C. Reporting Requirements Under Section 338(h)(10)

1. Section 338(h)(10)(C) provides that "Under regulations . . . the purchasing corporation and the common parent of the selling consolidated group shall, at such times and in such manner as may be provided in regulations, furnish to the Secretary the following information:"

a. The amount allocated to goodwill and going concern value.

b. Any modification to the amount allocated to goodwill and going concern value.

c. Any other information the Secretary deems necessary to carry out the provisions of the section 338(h)(10).

2. The Service has yet to issue regulations under section 338(h)(10) pertaining to the reporting requirements. However, the section 338(h)(10) regulations do provide that the section 338(h)(10) election shall be made on Form 8023 "Elections Under Section 338 for Corporations Making Qualified Stock Purchases" in accordance with the instructions to the form. Treas. Reg. § 1.338(h)(10)-1(c)(2).

3. With the release of Form 8883 and the issuance of temporary regulations under section 6043(c), Form 8023, which has been revised, is no longer the exclusive form to be filed concerning section 338 transactions.

4. In fact, section 338(h)(10) transactions now entail the filing with the IRS of at least two, and potentially as many as five, different forms -- Forms 8883 and 8023, and potentially Forms 8806, 1096, and 1099-CAP.

5. This section discusses Forms 8883 and 8023, and the following section (D) discusses the temporary section 6043(c) regulations, and the potential reporting obligations imposed thereunder (i.e., Forms 8806, 1096, and 1099-CAP). Note: The reporting requirements of the temporary section 6043(c) regulations may be applicable to both applicable assets acquisitions (i.e., section 1060 transactions) and section 338 transactions.

6. Form 8883

    a. Who Must File

        Both the Old Target and the New Target (or the parties reporting the tax results of the section 338 transaction) are required to file the Form 8883 (attached as Appendix B).

    b. When and How to File

        (1) Form 8883 must be attached to the timely filed tax returns that reflect the tax effects of the section 338(h)(10) transaction.

        (2) Old Target

            (a) In the case of a section 338(h)(10) election for an S corporation target, Form 8883 must be attached to Form 1120S (U.S. Income Tax Return for an S Corporation).

            (b) If the old target is a member of a selling group that will file a consolidated Federal income tax return, Form 8883 must be attached to the selling group's consolidated return for its tax year that includes the acquisition date.

            (c) If the old target is a member of an affiliated selling group that does not file a consolidated Federal income tax return, Form 8883 must be attached to the return that reflects the tax effects of the section 338(h)(10) transaction; generally, this will be the return for the old target corporation.

(3) New Target

(a) If the new target joins a group that will file a consolidated Federal income tax return, Form 8883 must be attached to the consolidated return that includes the day after the acquisition date.

(b) Otherwise, Form 8883 must be attached to the first return of the new target.

c. Required Information

Form 8883 requires the following information about transactions involving the deemed sale of corporate assets under section 338:

(1) The name, address, and employer identification number of the filing party (i.e., the taxpayer reporting the tax results of the section 338 transaction). The filing party also must check a box indicating whether its income tax return reflects the tax results of the Old Target or the New Target. The filing party also must indicate whether it has timely filed a valid Form 8023.

(2) The name, address, and employer identification number of the taxpayer that files the U.S. income tax return, if any, that reflects the tax results under section 338 for the other party to the transaction. The Instructions to Form 8883 clarify that if the tax results of the section 338 transaction for the other party are reported on a consolidated return, the filing party must identify the common parent of the consolidated group. If the other party is a controlled foreign corporation that does not file a U.S. income tax return, the filing party must identify as the other party the U.S. shareholder owning the largest interest in the CFC.

(3) The name, address, employer identification number (if any), and the state or country of incorporation of the target corporation. This information is only required if the target is not also the filing party; i.e., if the Form 8883 is filed by the common parent of a consolidated group including the target or by the seller, purchaser, or U.S. shareholder filing for a foreign target.

(4) Certain general information, including the acquisition date, what percentage of the target stock was acquired during the 12-month acquisition period and on the acquisition date, the stock price, the acquisition or selling costs, the amount

of the target's liabilities, the AGUB or ADSP, and information regarding the status of the target.

(5) The aggregate fair market value of the Class I, II, III, IV, V, and VI and VII assets and the allocation of AGUB or ADSP to each of those asset classes; Classes VI and VII are grouped together for purposes of reporting their aggregate fair market value and allocation of AGUB or ADSP.

(6) If the Form 8883 is being filed in order to amend a previously filed statement (because of an increase in AGUB or ADSP), the filing party must specify the amended aggregate fair market value of the Class I, II, III, IV, V, and VI and VII assets and the allocation of AGUB or ADSP to each of those asset classes. The filing party must also specify the reasons for the subsequent increase or decrease in AGUB or ADSP.

7. <u>Form 8023</u>

a. <u>Changes to Form 8023</u>

(1) Form 8023 (attached as Appendix C) was revised on account of the release of Form 8883 (discussed above).

(2) The instructions to the revised Form 8023 state that "[e]ach U.S. shareholder must also File Form 8883, Asset Allocation Statement Under Section 338, with Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations."

(3) The Purchasing Corporation's Statement, which was formerly contained in Section F of Form 8023, is now part of Form 8883.

(4) Form 8023 is no longer required to be attached to either the new target's, the old target's, or the purchasing corporation's income tax returns; instead, Form 8883 now must be attached to the return, and Form 8023 must now be filed by the 15th day of the 9th month after the acquisition date to make a section 338(h)(10) election for target.

(5) Form 8023, including those filed by foreign purchasing corporations, now must be filed with the Ogden processing center.

b. <u>Who must file</u>

The instructions to Form 8023 state that "[i]f a section 338(h)(10) election is made for a target, Form 8023 must be filed jointly by the purchasing corporation and the common parent of the selling consolidated group (or the selling affiliate or S corporation shareholder(s))."

(1) Under the old regulations, it was not clear whether all S corporation shareholders must consent to the section 338(h)(10) election, or merely those shareholders who sell their stock in the QSP.

(2) The final regulations clarify that all S corporation shareholders, selling or not, must consent to the making of the section 338(h)(10) election. See Treas. Reg. § 1.338(h)(10)-1(c)(2).

(3) The preamble to the final regulations provides that the Service will revise Form 8023 to make clear that nonselling S corporation shareholders must also sign Form 8023. The preamble also provides that the Service will recognize the validity of otherwise valid elections made on the current version of Form 8023 even if not signed by the nonselling shareholders, provided that the S corporation and all of its shareholders (including nonselling shareholders) report the tax consequences consistently with the results under section 338(h)(10).

(4) Form 8023 has since been revised, and the Instructions thereto clarify that “[i]f the target is an S corporation, a section 338(h)(10) election must be made by all of the shareholders of the target, including the shareholders who do not sell target stock in the QSP.”

c. When and Where to File

(1) Form 8023 must be filed by the 15th day of the 9th month after the acquisition date to make a section 338(h)(10).

(2) Form 8023 must be filed with the Internal Revenue Service, Submission Processing Center. P.O. Box 9941, Mail Stop 4912, Ogden, UT 84409.

(3) Multiple Targets

One Form 8023 may be used for section 338(h)(10) elections for multiple targets if:

(a) Each target has the same acquisition date;

(b) Each target was a member of the same affiliated group immediately before the acquisition date; and

(c) Each target is a member of the same affiliated group immediately after the acquisition date.

d. Required Information

Form 8023 requires the following information about section 338(h)(10) elections:

(1) The purchasing corporation's name, address, employer identification number, the date its tax year ends, and the state or country of incorporation. If more than one member of an affiliated group purchases stock of the acquired target, the information for the corporation that acquired the largest percentage of target stock must be listed on the Form; in this case, the instructions require that the parties attach to the Form 8023 a schedule providing the requisite information for each purchasing corporation (other than the corporation listed on the Form as the purchasing corporation) and providing information regarding which target stock was acquired by each purchasing corporation.

(2) If the purchasing corporation is a member of a consolidated group, the common parent's name, address, employer identification number, the date its tax year ends, and the state or country of incorporation.

(3) The target corporation's name, address, employer identification number, the date its tax year ends, and the state or country of incorporation.

(4) If the there is a section 338(h)(10) election or if the target was either a member of a consolidated group or a controlled foreign corporation (or was a CFC within the preceding five years), the name, address, tax identification number(s), and the date the tax year ends for the common parent of the selling consolidated group, selling affiliate, U.S. shareholders of the foreign target corporation, or S corporation shareholders.

(5) The acquisition date and information regarding the percentage of the target stock acquired during the 12-month acquisition period and on the acquisition date (i.e., whether multiple elections are being made).

(6) The type of election being made by the party or parties and whether an election is being made for a corporation or corporations other than the target.

(7) The signature(s) of the purchasing corporation(s) and, in the case of a section 338(h)(10) election, the signature of the common parent, selling affiliate, or the S corporation shareholders.

e. Prior to its revision, Form 8023 required other information (now required by Form 8883), including information regarding the amount and allocation of AGUB and ADSP.

f. The preamble to the proposed regulations indicated that the Service and Treasury were considering whether the information regarding the amount and allocation of AGUB and ADSP submitted on the Form 8023 (then in effect) should instead be submitted by the purchaser and seller separately on their income tax returns.

g. This information now must be provided on the Form 8333, which must be filed along with both the seller and purchaser's tax return.

D. Reporting Requirements Under Section 6043(c)

1. Temporary regulations under section 6043(c) (the "temporary regulations") require certain domestic corporations (the "reporting corporation") to report (on Form 8806) information regarding transactions in which (i) control of that corporation is acquired, or where (ii) the corporation either recapitalizes or undergoes a substantial change in corporate structure. Temp. Treas. Reg. § 1.6043-4T, T.D. 9022, 2002-48 I.R.B. 909 (Dec. 2, 2002).

2. If applicable, the temporary regulations also require the reporting corporation (i) to report to the IRS certain information about its shareholders (on Forms 1096 and 1099-CAP), and (ii) to furnish to its shareholders the Form 1099-CAP filed with the IRS.

3. By expressly providing that a QSP and subsequent 338 election will be treated as an acquisition of stock, rather than an acquisition of assets, the temporary regulations clarify that section 338 transactions are generally subject to the reporting requirements of section 6043 (i.e., the filing of the Form 8806, 1096, and 1099-CAP). See Temp. Treas. Reg. § 1.6043-4T(c)(5).

4. Moreover, by defining "a substantial change in capital structure" to include a transaction or series of transactions in which one corporation "Merges, consolidates or otherwise combines with another corporation or

transfers all or substantially all of its assets to one or more corporations," the temporary regulations may also apply to certain large applicable assets acquisitions from domestic corporations. Temp. Treas. Reg. § 1.6043-4T(d)(2)(iii).

5. However, the temporary regulations do not require information reporting for every transaction that results in a change of control or that involves a recapitalization or a substantial change in corporate structure.

    a. The temporary regulations only apply to acquisitions of control and changes in the capital structure of domestic corporations. Temp. Treas. Reg. § 1.6043-4T (a)(1). Thus, asset acquisitions where the target is a foreign corporation or a non-corporation business entity and certain section 338(g) elections (those involving foreign targets) may be exempt from the additional reporting requirement.

    b. Moreover, the temporary regulations only apply where the fair market value of stock in the acquired corporation or the fair market value of the consideration ultimately transferred to the acquired corporation's shareholders (in exchange for the assets of the acquired corporation) exceeds $100,000,000. Temp. Treas. Reg. § 1.6043-4T(c)(1)(C),(D).

    c. Thus, the reporting requirements of the temporary regulations only apply to transactions involving domestic target corporations, and only where the consideration exchanged exceeds $100 million.

6. Form 8806

    a. Who Must File

        (1) The acquired (or target) corporation is the party required to file the Form 8806 (i.e., the reporting corporation). Temp. Treas. Reg. § 1.6043-4T(a)(1).

            (a) However, in the case of an acquisition of substantially all of the assets of the target corporation (i.e., a substantial change in the capital structure), the acquiring corporation is secondarily responsible for filing the Form 8806 and is jointly liable for any penalties imposed as a result of either party's failure to file the Form 8806. Temp. Treas. Reg. § 1.6043-4T(e).

            (b) This rule should not apply in the case of a section 338 election because under Temp. Treas. Reg. § 1.6043-4T(c)(5), a QSP and section 338 election is

treated as an acquisition of stock, rather than assets, for purposes of the temporary regulations.

(2) In general, the reporting corporation must file the Form 8806 if:

(a) As a result of the acquisition, the shareholders of the reporting corporation receive cash, stock, or other property pursuant to the transaction;

(b) The proceeds from the transaction are at least $100 million; and

(c) There is either (i) an acquisition of control of the reporting corporation, or (ii) a substantial change in the capital structure of the reporting corporation. Temp. Treas. Reg. § 1.6043-4T(a)(1).

i) Acquisition of control occurs where, as a result of a transaction or series of related transactions:

a) Stock representing control of the first corporation is distributed by a second corporation to shareholders of the second corporation, or

b) Before an acquisition of stock of the first corporation (directly or indirectly) by a second corporation, the second corporation does not have control of the first corporation, but after the acquisition the second corporation has control of the first corporation. Temp. Treas. Reg. § 1.6043-4T(c)(1).

c) "Control" is defined by reference to section 304(c)(1). Temp. Treas. Reg. § 1.6043-4T(c)(2). Section 304(c)(1) defines control as the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock.

d) The constructive ownership rules of section 318(a) apply in determining whether an acquisition of control has occurred; however these rules do not apply in determining whether the acquirer has control of the acquired corporation before the transaction. Temp. Treas. Reg. § 1.6043-4T(c)(3).

ii) A "substantial change in the capital structure of a domestic corporation" includes:

a) A recapitalization with respect to stock;

b) A redemption of stock (including deemed redemptions);

c) Mergers, consolidations (or otherwise combining with another corporation), and transfers of all or substantially all of the corporation's assets to one or more corporations;

d) Transfers of all or part of the corporation's assets to another corporation in a title 11 or similar case and, in pursuance of the plan, stock or securities of that corporation is distributed; or

e) Changes in a corporation's identity, form, or place of organization. Temp. Treas. Reg. § 1.6043-4T(d).

(3) However, Form 8806 does not have to be filed if:

(a) Information regarding the transaction was already properly filed pursuant to Treas. Reg. §§1.351-3(b), 1.355-5(a), or 1.368-3(a); or

(b) The corporation reasonably determines that all of its shareholders who receive cash, stock, or other property pursuant to the acquisition of control or substantial change in capital structure are exempt recipients as defined under Temp. Treas. Reg. § 1.6043-4T(b)(6).

b. When and How to File

(1) Form 8066 must be filed by the reporting corporation within 45 days after (i) control (defined under section 304(c)) of the corporation is acquired, or (ii) the corporation undergoes a substantial change in capital structure (as defined in the regulations), or if earlier, on or before January 5th of the year following the calendar year in which the acquisition of control or substantial change in capital structure occurs.

(2) Reporting Corporations may elect on Form 8806 to consent to the publication by the IRS of information necessary for brokers to file information returns with respect to their customers. If a corporation makes the election to permit the IRS to publish information regarding the transaction, then the corporation is not required to file Forms 1099-CAP with respect to its shareholders that are clearing organizations, or to furnish Forms 1099-CAP to such clearing organizations.

c. Required Information

If the temporary regulations apply, the reporting corporation must include the following information on the Form 8806:

(1) The name, address, and taxpayer identification number (TIN) of the reporting corporation;

(2) If immediately prior to the transaction the reporting corporation was a subsidiary member of an affiliated group filing a consolidated return, the name, address, and TIN of the common parent of that affiliated group;

(3) The name, address, and TIN of the acquiring corporation. Also, the reporting corporation must state whether the acquiring corporation is foreign (as defined in section 7701(a)(5)) or is a dual resident corporation (as defined in §1.1503-2(c)(2)), and in either case, whether the acquiring corporation was newly formed prior to its involvement in the transaction;

(4) If the acquiring corporation was a subsidiary member of an affiliated group filing a consolidated return immediately prior to the acquisition, the name, address, and TIN of the common parent of that affiliated group; and

(5) General information about the transaction, including:

(a) A description of the transaction or transactions that gave rise to the acquisition of control or the substantial change in the capital structure of the corporation;

(b) The date or dates of the transaction or transactions that gave rise to the acquisition of control or the substantial change in capital structure;

(c) A description and statement of the fair market value of any stock provided to the reporting corporation's shareholders in exchange for their stock, but only if the reporting corporation reasonably determines that the shareholders are not required to recognize gain (if any) from the receipt of such stock for U.S. federal income tax purposes; and

(d) A statement of the aggregate amount of cash plus the fair market value of any property (including stock, but excluding stock received without recognition of gain) provided to the reporting corporation's shareholders in exchange for their stock. Temp. Treas. Reg. § 1.6043-4T(a)(1)(i)-(v).

7. <u>Form 1099-CAP</u>

a. Corporations that are required to file Form 8806 must also file Forms 1096 and 1099-CAP (attached as Appendix E).

b. Form 1096 is little more than a cover sheet indicating that the reporting corporation is filing a Form 1099-CAP. As a result, Form 1096 is not discussed in further detail; however, taxpayers must recognize that this Form must be filed in along with each Form 1099-CAP.

c. As discussed below, one Form 1099-CAP must be filed for each shareholder of record in the reporting corporation who receives cash, stock, or other property in the transaction; each Form 1099-CAP must include a Form 1096.

d. Furthermore, the reporting corporation that files a Form 1099-CAP with respect to a shareholder must also furnish the Form to that shareholder.

e. <u>Who Must File</u>

The corporation that filed the Form 8806 is the party that must file Form(s) 1099-CAP.

f. When and How to File

(1) The reporting corporation must file with the IRS Forms 1096 and 1099-CAP on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the acquisition of control or the substantial change in capital structure occurs.

(2) Moreover, the reporting corporation must furnish to each shareholder the Form 1099-CAP filed with respect to that shareholder by January 31 of the year following the calendar year in which the shareholder receives cash, stock, or other property as part of the acquisition of control or the substantial change in capital structure.

(3) The reporting corporation is not required a Form 1099-CAP for the following shareholders:

(a) Any shareholder who receives solely stock described in exchange for its stock in the corporation in a tax-free transaction;

(b) Any shareholder who does not receive in the transaction cash, stock, or other property in excess of $1000; and

(c) Any shareholder who has properly completed and provided to the reporting corporation an exemption certificate (as provided in Treas. Reg. § 31.3406(h)-3A). Temp. Treas. Reg. § 1.6043-4T(b)(6).

g. Required Information

The Form 1099-CAP filed with respect to each shareholder must include:

(1) The name, address, telephone number and TIN of the reporting corporation;

(2) The name, address and TIN of the shareholder;

(3) The number and class of shares in the reporting corporation exchanged by the shareholder;

(4) The amount of cash and the fair market value of any stock (other than stock received tax-free) or other property provided to the shareholder in exchange for its stock; and

(5) The date of the sale or exchange.

(6) Note: Additional requirements may apply with respect to Forms 1099-CAP filed by brokers.

PART TWO: ANALYSIS OF SECTION 197 AND ITS APPLICATION

I. HISTORICAL DEVELOPMENT OF SECTION 197

A. The Omnibus Budget Reconciliation Act of 1987

1. The legislative background to section 197 dates back to 1987. In that year, the House of Representatives, in its version of H.R. 3545, The Omnibus Budget Reconciliation Act of 1987, included a provision that would have treated amounts paid or incurred to acquire customer base, market share, and similar intangible assets "as if paid or incurred for intangible property with an indeterminate useful life." Section 10120 of H.R. 3545 (passed by the House of Representatives on Oct. 29, 1987).

2. The provision was deleted by the Conference Committee.

3. In 1990, the Service rekindled the controversy concerning the tax treatment of acquired intangible assets. Congress entered the foray in 1991, and the end result this time was vastly different than in 1987.

B. The Service's Industrial Specialization Program (ISP) Position Paper

1. In July 1990, the Service issued an ISP position paper relating to customer-based intangibles. The issue addressed by the paper was the following: "In the acquisition of a going business, whether customer based intangible assets, to which the purchase price has been allocated, are amortizable under section 167. In other words, whether the particular customer based intangible is an asset separate and distinct from the goodwill of the acquired business." IRS Retail Industry Specialization Program, Coordinated Issue Paper, Customer-Based Intangibles, reprinted in Tax Analysts Special Supp. Vol. 5, Number 17, at 344 (May 2, 1991).

2. The Service concluded that "if the customer based intangible represents the customer structures of the acquired business, and that business possesses characteristics of goodwill, then the intangible is inseparable from goodwill, and thus, is nonamortizable as a matter of law." Id. at 344.

3. By issuing this position paper, the Service staked out a position that allowed for little compromise. Thus, it was left up to Congress to resolve the issue.

C. H.R. 563

1. On January 18, 1991, Representative Brian Donnelly introduced H.R. 563.

2. Like the provision passed by the House of Representatives in 1987, H.R. 563 would have amended section 167 to provide that any amount paid or incurred to acquire customer base, market share, or any similar intangible item would be treated as paid or incurred for intangible property with an indeterminate useful life.

D. H.R. 1456 and S. 1245

1. On March 18, 1991, Representatives Guy Vander Jagt, Beryl Anthony, and Barbara Kennelly introduced H.R. 1456. On the Senate side, on June 3, Senators Thomas Daschle and Steve Symms introduced S. 1245, which was virtually identical to H.R. 1456.

2. H.R. 1456 and S. 1245 would have allowed the value of customer-based intangibles, market share, and any similar intangible item to be amortizable over the period of its useful life provided that the taxpayer could demonstrate that the intangible asset had

   a. an ascertainable value separate and distinct from other assets (including goodwill and going concern value) and

   b. a limited useful life, the length of which can be reasonably estimated.

3. In effect, H.R. 1456 and S. 1245 codified the two-prong test established by the Fifth Circuit Court of Appeals almost twenty years earlier in Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974), and relied on by the Service in Rev. Rul. 74-456, 1974-2 C.B. 65.

E. H.R. 3035

1. Before the House Ways and Means Committee began considering the competing bills, Rep. Dan Rostenkowski introduced a new and innovative alternative.

2. H.R. 3035, introduced by Rep. Rostenkowski on July 25, 1991, represented a significant departure from current law by permitting, for the first time since the issuance of Treasury Regulations in 1927, the amortization of amounts allocable to goodwill and going concern value.

a. The bill provided that amounts allocable to a variety of acquired intangible assets, including goodwill and going concern value, would be amortizable ratably over a 14-year period beginning in the month of the acquisition.

b. Not everyone would benefit from the bill, however -- the provision had the effect of significantly lengthening the recovery period for many intangibles, such as covenants not to compete, that were eligible under current law for a shorter recovery period.

3. The 14-year period was chosen because it made the bill revenue neutral.

F. Legislative Initiatives in 1992 Affecting Intangibles

1. H.R. 4210 -- The Tax Fairness and Economic Growth Act of 1992

a. H.R. 4210 was Congress' response to President Bush's challenge to Congress (delivered in his 1992 State of the Union address) to quickly pass legislation that would stimulate the economy.

b. H.R. 4210 included a statutory provision for the amortization of acquired intangible assets that was virtually identical to the one contained in H.R. 3035. See section 4501 of H.R. 4210.

c. The amortization provision contained in H.R. 4210 also included an election whereby a taxpayer could elect to apply the amortization provision to all property acquired by the taxpayer in any taxable year for which the statute of limitations for the assessment of tax had not expired as of July 25, 1991, except that the amortization period would be 17 years (as opposed to the 14-year rule that applied on a prospective basis).

d. President Bush vetoed H.R. 4210 on March 20, 1992, the same day that Congress passed it.

2. H.R. 11 – The Revenue Act of 1992

a. H.R. 11, passed by Congress on October 5, 1992, also included a statutory provision for the amortization of acquired intangible assets that was virtually identical to H.R. 3035. See section 4501 of H.R. 11.

b. Unlike H.R. 4210, however, H.R. 11 did not include a statutory remedy for those cases involving intangible assets that were already pending with the Service. Instead, the Conference Report accompanying H.R. 11 included the following statement:

The purpose of the provision is to simplify the law regarding the amortization of intangibles. The severe backlog of cases in audit and litigation is a matter of great concern to the conferees; and any principle established in such case will no longer have precedential value due to the provision contained in the conference agreement. Therefore, the conferees urge the Internal Revenue Service in the strongest possible terms to expedite the settlement of cases under present law. In considering settlements and establishing procedures for handling existing controversies in an expedient and balanced manner, the conferees strongly encourage the Internal Revenue Service to take into account the principles of the bill so as to produce consistent results for similarly situated taxpayers. H.R. Conf. Rep. 102-1034, at 938.

c. President Bush vetoed H.R. 11 on November 5, two days after the 1992 presidential elections.

G. Developments in 1993 Affecting Intangibles

1. H.R. 13

a. On January 5, 1993, the first day of the 103d Congress, Rep. Rostenkowski introduced H.R. 13, the Tax Simplification Act of 1993.

b. H.R. 13 included the intangibles provision that was contained in H.R. 11.

2. The Supreme Court Decision in *Newark Morning Ledger*

a. There was some concern that the intangibles legislation would not be enacted, given that the Clinton Administration's list of revenue proposals did not include the legislation. This became less of a concern after the Supreme Court's decision in Newark Morning Ledger Co. v. Commissioner, 113 S. Ct. 1670 (1993), rev'g 945 F. 2d 555 (3d Cir. 1991).

(1) In Newark Morning Ledger, the Supreme Court affirmed the principles established by the Fifth Circuit in Houston Chronicle Publishing Co., and ruled that the acquisition cost allocable to a customer-based intangible (in this case, a list of paid subscribers), can be amortized if the taxpayer satisfies its substantial burden of proving that the asset can be valued and has a limited useful life, regardless of how much the asset appears to reflect the expectancy of continued patronage.

(2) The Court specifically rejected the approach taken by the Third Circuit, which had held that a customer list was per se goodwill, and hence nonamortizable notwithstanding that the asset may have a limited useful life that can be ascertained with reasonable accuracy.

b. From a political perspective, the Newark Morning Ledger decision was critical in two respects:

(1) By concluding that the determination of whether an asset is capable of being valued and whether that value diminishes over time were questions of fact, the case reinforced the policy argument that a legislative solution to the intangibles issue was necessary in order to eliminate lengthy and costly litigation that would have little precedential value.

(2) Perhaps more significantly, the decision forced the government to adjust its revenue estimates with respect to the intangibles legislation.

(a) The intangibles provision contained in H.R. 11 was scored as raising $425 million over the five-year budget period.

(b) Following the Newark Morning Ledger decision, the same provision was scored as raising $2.097 billion over the same period.

(c) As a result, many more legislators became interested in the intangibles legislation.

3. H.R. 2264 – The Omnibus Budget Reconciliation Act of 1993

a. House version

The House version of the 1993 Act included the intangibles legislation as it was contained in H.R. 13.

b. Senate version

The Senate version of the 1993 Act also included the intangibles legislation, but with a number of amendments:

(1) The amount of deduction with respect to any amortizable intangible was determined by amortizing 75 percent of the adjusted basis of the intangible asset over 14 years; the remaining 25 percent was not amortizable;

(2) Purchased mortgage servicing rights not acquired with a trade or business would be amortized over a nine-year period; and

(3) Certain computer software acquisitions would be amortized as follows: 50 percent of the amortizable basis (i.e., 50 percent of the 75 percent allowed under the Senate version) would be amortized over five years; the remaining 50 percent (of the 75 percent) would be amortized over 14 years.

c. Conference report

Not surprisingly, the Conference agreement reflects a comprise of the two versions.

(1) The amortization period applicable to acquired intangible assets is 15 years (instead of 14 years), and the entire amount allocated to the intangible qualifies for the amortization deduction (as opposed to 75 percent as in the Senate version).

(2) Purchased mortgage servicing rights not acquired with a trade or business are excluded from the 15-year rule and instead are amortized over a period of nine years (as in the Senate version).

II. ANALYSIS OF SECTION 197

A. Overview

Section 197 has a profound effect on acquisition transactions. By its terms, the 15-year amortization period applies to any "amortizable section 197 intangible" that (i) is acquired after August 10, 1993, and (ii) "is held in connection with the conduct of a trade or business or any activity described in section 212." Section 197(c)(1). In January 1997, the Service issued proposed regulations under section 197. See Prop. Treas. Reg. § 1.197-2. On January 20, 2000, the Service issued final regulations under Section 197. See 65 Fed. Reg. 3,820 (Jan. 25, 2000). The applicable definitions and special rules under section 197 are described below.

1. NOTE: The proposed regulations provided that section 197 did not apply to any amount paid or incurred for a section 197 intangible if the deduction for such amount would be disallowed by another section of the Code (except section 263). Prop. Treas. Reg. § 1.197-2(a)(4). Thus, if a corporation acquires a covenant not to compete in connection with a stock redemption, section 197 would not apply because section 162(k) disallows deductions for any amount paid or incurred in connection with the

reacquisition of a corporation's own stock. See Prop. Treas. Reg. § 1.197-2(k), Ex.4. But see P.L.R. 9240010 (June 30, 1992).

2. Many practitioners believed that while the result in Prop. Treas. Reg. § 1.197-2(k), Ex. 4 may be correct, the regulation's analysis was incorrect.

   a. In the example, a corporation, in connection with a stock redemption, entered into a non-competition agreement with a shareholder, whereby the corporation would pay the shareholder a specified amount for not competing with the corporation for a period of three years. The corporation and the shareholder had no business relationship other than the corporation-shareholder relationship. Under the example, section 197 did not apply to the amounts incurred pursuant to the non-competition agreement, because the agreement was entered into in connection with the reacquisition of the corporation's stock under section 162(k). Therefore, section 162(k) disallows any deduction.

   b. Although not stated in the example, because the shareholder and the corporation in the example have no business relationship other than the corporation-shareholder relationship, the payment under the covenant not to compete arguably should be deemed an additional payment for the shareholder's stock. Thus, section 162(k) would disallow deductions for amounts paid pursuant to the agreement, as such amounts are paid in connection with the reacquisition of the corporation's stock.

3. The final regulations remove § 1.197-2(a)(4) and § 1.197-2(k), Ex. 4. The Preamble states that "[c]ommentators suggested that guidance on the application of section 162(k) to transactions involving section 197 intangibles should be addressed under section 162(k)." Preamble to Treas. Reg. § 1.197, 65 Fed. Reg. 3,820, 3,821 (Jan. 25, 2000) (the "Preamble").

B. Definitions

1. An "Amortizable Section 197 Intangible"

   a. Section 197(c) defines the term "amortizable section 197 intangible" as referring to a section 197 intangible that is

      (1) acquired after the date of enactment of the statute (except for the special elections noted below), and

      (2) held in connection with the conduct of a trade or business or an activity described in section 212. See Treas. Reg. § 1.197-2(d)(1).

b. The term does not include certain section 197 intangibles created by the taxpayer (self-created intangibles). See Section 197(c)(2); Treas. Reg. § 1.197-2(d)(2)(i).

(1) An intangible is self-created to the extent the taxpayer makes payments or otherwise incurs costs for its creation or improvement, whether the actual work is done by the taxpayer or by another person under a contract with the taxpayer. Treas. Reg. § 1.197-2(d)(2)(ii).

(2) The following self-created intangibles are excluded from the definition of amortizable Section 197 intangibles:

(a) goodwill;

(b) going concern value;

(c) workforce in place;

(d) information-based intangibles;

(e) know-how intangibles;

(f) customer-based intangibles;

(g) supplier-based intangibles; and

(h) any similar items.

Section 197(c)(2), (d)(1).

(3) The exception for self-created intangibles does not apply, however, if the intangible is created in connection with a transaction involving the acquisition of assets constituting a trade or business or a substantial portion thereof. Section 197(c)(2); see Treas. Reg. § 1.197-2(d)(2)(iii)(B). Thus, intangibles created in connection with such an acquisition will be treated as amortzable section 197 intangibles.

(a) A group of assets constitutes a trade or business or a substantial portion thereof if their use would constitute a trade or business under section 1060 (that is, if goodwill or going concern value could, under any circumstances, attach to the assets). Treas. Reg. § 1.197-2(e)(1).

i) The proposed regulations treated a group of assets as per se constituting a trade or

business or a substantial portion thereof if the assets included customer-based intangibles. Prop. Treas. Reg. § 1.197-2(e)(2).

ii) Because this exception for customer-based intangibles was not contained in the legislative history of section 197, the final regulations eliminated it. See Preamble, 65 Fed. Reg. at 3,821.

iii) The proposed regulations also generally treated any franchise, trademark, or trade name as per se constituting the acquisition of a trade or business or a substantial portion thereof. Prop. Treas. Reg. § 1.197-2(e)(3). The final regulations retain this rule. Treas. Reg. § 1.197-2(e)(2).

iv) A qualified stock purchase treated as an asset purchase under section 338 constitutes the acquisition of a trade or business or a substantial portion thereof only if the direct acquisition of the assets of the corporation would have been treated as the acquisition of assets constituting a trade or business. Treas. Reg. § 1.197-2(e)(5).

v) Under recently finalized regulations, the mere reinsurance of insurance contracts by an insurance company does not qualify as the acquisition of a trade or business and, therefore, is not an applicable asset acquisition. However, the transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill or going concern value could attach. Treas. Reg. § 1.1060-1(b)(9).

(b) Whether acquired assets constitute a "substantial portion" of a trade or business is based on all the relevant facts and circumstances. Treas. Reg. § 1.197-2(e)(4).

2. A "Section 197 Intangible"

a. In general

For purposes of section 197, acquired intangible assets generally can be grouped into four categories:

(1) intangibles that will always be treated as a "section 197 intangible" (goodwill; going concern value; workforce intangibles; information-based intangibles; know-how intangibles, customer-based intangibles, supplier-based intangibles, licenses, permits, or other rights granted by a governmental unit; and franchises, trademarks, or trade names);

(2) intangibles that will be treated as a section 197 intangible if there is a related direct or indirect acquisition of a trade or business or substantial portion thereof (a covenant not to compete; specialized computer software; any interest in a film, sound recording, video tape, book, or similar property; a contractual right to receive tangible property or services; any interest in a patent or copyright; any right to service mortgage indebtedness secured by residential real property; and insurance contracts acquired in assumption reinsurance transactions); and

(3) intangibles that will never be treated as a section 197 intangible (a financial interest; an interest in land; off-the-shelf computer software; an interest in a tangible property lease or a debt instrument; a professional sports franchise; and certain transactional costs). See Section 197(d), (e).

b. Specific intangible assets

In particular, section 197(d)(1) defines the term "section 197 intangible" as including the following:

(1) goodwill -- the value of a trade or business that is attributable to the expectancy of continued consumer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor.[2] See Treas. Reg. § 1.197-2(b)(1).

(2) going concern value -- the additional value of a trade or business derived from its existence as an integral part of a

[2] Section 197(d)(1)(A); H.R. Conf. Rep. No. 103-213, at 674 (1993) ("Conference Report").

going concern. This term includes the value attributable to the ability of a trade or business to continue to generate income without interruption, notwithstanding a change in ownership. The term does not include any other intangible described in Treas. Reg. § 1.197-2(b). See Treas. Reg. § 1.197-2(b)(2).

(3) workforce intangibles -- assembled workforce, the composition of a workforce, the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a highly-skilled workforce is a section 197 intangible. See Treas. Reg. § 1.197-2(b)(3).

(4) information-based intangibles -- business books and records, operating systems, and any other information base, including information on current or prospective customers. Thus, for example, the cost of acquiring customer lists, subscription lists, insurance expirations, patient or client files, or lists of newspaper, magazine, radio, or television advertisers is a section 197 intangible. See Treas. Reg. § 1.197-2(b)(4).

(5) "know-how" intangibles -- patents, copyrights, formula, process, design, pattern, know-how, format or other similar item. This category includes items such as package designs, and any interest in a film, sound recording, video tape, book, or other similar property. See Treas. Reg. § 1.197-2(b)(5).

(6) customer-based intangibles -- composition of market, market share, and other value resulting from the future provision of goods or services pursuant to relationships to customers (contractual or otherwise) in the ordinary course of business. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business attributable to the existence of insurance in force, mortgage servicing contracts, a circulation base, or undeveloped market or market growth is a section 197 intangible. On the other hand, the portion of purchase price attributable to accounts receivable or other similar rights to income is not to be taken into account for purposes of section 197. See Treas. Reg. § 1.197-2(b)(6).

(a) NOTE: Rights to receive Rule 12b-1 fees and contingent deferred sales charges are customer-based intangibles, if they are attributable to future services. P.L.R. 9549007 (Sept. 6, 1995).

(7) supplier-based intangibles -- the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) with suppliers of goods or services to be used or sold by the taxpayer. Thus, for example, the portion of the purchase price of an acquired trade or business attributable to the existence of a favorable relationship with persons that provide distribution services is a section 197 intangible. However, supplier-based intangibles do not include amounts paid for the goods or services themselves pursuant to the terms of the agreement or relationship. See Treas. Reg. § 1.197-2(b)(7). See also T.A.M. 9840001 (Apr. 10, 1998) (ruling that enrollment fee that allowed taxpayer to sell customer notes indefinitely was a supplier-based intangible).

(8) licenses, permits, or other rights granted by a governmental unit -- liquor licenses, taxicab licenses, airport landing or take-off rights, regulated airline routes, or television or radio broadcasting licenses. For purposes of section 197, the issuance or renewal of a license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof is to be considered an acquisition of such license, permit, or other right. See Treas. Reg. § 1.197-2(b)(8). See e.g., FSA 200137023 (June 13, 2001) (ruling that a certificate issued by a governmental agency to apply for a manufacturing license is a section 197 intangible); ILM 200137050 (Aug. 8, 2001) (Personal communication service ("PCS") licenses are section 197 intangibles).

(9) covenants not to compete -- covenant not to compete or other similar arrangements entered into in connection with the acquisition of a trade or business or a substantial portion thereof. For purposes of section 197, an interest in a trade or business includes not only the assets of a trade or business, but also stock and partnership interests in corporations or partnerships engaged in a trade or business. In addition, employment contracts of former owners that benefit the trade or business being sold will be treated as covenants not to compete to the extent that amounts paid under such contracts are greater than a reasonable payment for those services. See Treas. Reg. § 1.197-2(b)(9). See

also Frontier Chevrolet Co. v. Commissioner, 116 T.C. 23 (2001) (redemption of stock constitutes an acquisition of an interest in a trade or business requiring amortization of covenant not to compete over 15 year period), aff'd 2003-1 USTC ¶50,490 (9th Cir. 2003); Sharewell, Inc.v. Commissioner, T.C. Memo 1999-413 (allowing corporation to amortize amounts paid in stock acquisition that are allocable to noncompete agreement).

(10) franchises, trademarks or trade names -- for purposes of section 197, the term "franchise" has the same meaning as that used under section 1253(b)(1). As such, "franchise" includes any agreement that provides one of the parties the right to distribute, sell, or provide goods, services, or facilities, within a specified area. Further, the renewal of a franchise, trademark, or trade name is to be treated as an acquisition of such franchise, trademark, or trade name. Present law under section 1253(d)(1), which regulates the tax treatment of contingent payments paid or incurred on account of the transfer of a franchise, trademark, or trade name, remains unchanged. However, the rules pertaining to the amortization of fixed and contingent payments for franchises, trademarks, and trade names have been repealed. See Treas. Reg. § 1.197-2(b)(10).

(11) other similar items -- any other intangible property similar in all material respects to workforce intangibles, information-based intangibles, "know-how" intangibles, customer-based intangibles, or supplier-based intangibles. See Treas. Reg. § 1.197-2(b)(12).

(12) contracts for the use of, and term interests in, other section 197 intangibles -- any right under a license, contract, or other arrangement providing for the use of property that would be a section 197 intangible under any of the above provisions. See Treas. Reg. § 1.197-2(b)(11).

c. Exceptions to section 197 intangibles

(1) Section 197(e) excepts certain assets from the definition of a section 197 intangible.

(2) Several of these exceptions apply only if the intangible property is not acquired in a transaction that involves the acquisition of a trade or business. The acquisition of a group of assets will constitute the acquisition of a trade or business if the use of such assets would constitute a trade or

business for purposes of section 1060. Treas. Reg. § 1.197-2(e), (e)(1). See e.g., PLR 200416002 (purchase of patents and trademarks did not constitute acquisition of assets constituting a trade or business and therefore the patents and trademarks did not constitute section 197 intangibles).

(3) Pre-Section 197 law continues to control the tax treatment of assets excluded from section 197.

(4) The excluded assets include:

(a) financial interests -- the term “Section 197 Intangible” does not include the following interests:

i) any interest in a corporation, partnership, trust, or estate (whether or not such interests are traded on an established market). See Section 197(e)(1)(A); Treas. Reg. § 1.197-2(c)(1).

ii) any interest under a futures contract, foreign currency contract, notional principal contract, interest rate swap, or similar contract. However, mortgage servicing contracts, credit card servicing contracts, and any interest under an assumption reinsurance contract are not included in this exclusion. See Section 197(e)(1)(B); Treas. Reg. § 1.197-2(c)(2).

(b) any interest in land -- the term "section 197 intangible" does not include any fee interests, leaseholds, life estates, remainder interests, easements, timber, mineral, grazing, riparian, or air rights, zoning variations, and any similar interests. An interest in land does not include an airport landing or take-off right, a regulated airline route, or a franchise to provide cable television services. See Treas. Reg. § 1.197-2(c)(3).

(c) off-the-shelf computer software -- the term "section 197 intangible" does not include computer software that (i) is readily available to the public off-the-shelf, (ii) is subject to a non-exclusive license, and (iii) has not been substantially modified. See Section 197(e)(3)(A)(i); Treas. Reg. § 1.197-2(c)(4).

i) The term "computer software" refers to any sequence of machine-readable code that is designed to cause a computer to perform a desired function, and the documentation required to describe and maintain those programs. See Section 197(e)(3)(B); Treas. Reg. § 1.197-2(c)(4)(iv).

ii) This includes any incidental and ancillary rights with respect to computer software that (i) are necessary to effect the legal acquisition of the title to the computer software, and (ii) are used only in connection with the computer software. It includes "all forms and media in which the software is contained, whether written, magnetic, or otherwise." Id.

iii) It does not include any data base or similar item, unless the item is in the public domain and is incidental to the computer program. It also does not include amounts that are not chargeable to a capital account and that would otherwise be deductible. See Treas. Reg. § 1.197-2(c)(4)(iii), -2(a)(3). In addition, it does not include any amount that is included in the cost of hardware or other tangible property. See Treas. Reg. § 1.197-2(c)(4)(iii), -2(g)(7). Such amounts are treated as part of the cost of the hardware or tangible property. Treas. Reg. § 1.197-2(g)(7).

iv) Computer software is "readily available" to the public if it "may be obtained on substantially the same terms by a significant number of persons that would reasonably be expected to use the software." See Treas. Reg. § 1.197-2(c)(4)(i).

v) The section 197 regulations provide a safe harbor for purposes of the "substantially modified" requirement. See Treas. Reg. § 1.197-2(c)(4)(i). Computer software is not substantially modified if the cost of all modifications to the version of the software that is readily available to the general public

does not exceed the greater of: (1) $2,000, or (2) 25 percent[3] of the price at which the unmodified version of the software is readily available to the general public. Id.

vi) For guidance regarding the amortization of costs incurred to acquire, develop, and implement computer software and hardware, see Rev. Proc. 2000-50, 2000-2 C.B. 601; P.L.R. 200236028 (June 4, 2002).

(d) any interest in a lease of tangible property -- the term "section 197 intangible" does not include any interest of a lessor or lessee under an existing lease of tangible property. See Section 197(e)(5)(A); Treas. Reg. § 1.197-2(c)(8).

i) In the case of any interest as a lessor that is acquired by purchase, such cost is taken into account as part of the cost of the tangible property.

ii) In the case of any interest as a lessee that is acquired by purchase, such cost is taken into account under present law (i.e., section 178 and Treas. Reg. § 1.162-11(a)). If the lessee interest is acquired with any other intangible property, the portion of the total purchase price that is allocable to such interest is not to exceed the excess of (i) the present value of the fair market value rent for the use of the tangible property for the term of the lease, over (ii) the present value of the rent reasonably expected to be paid for the use of the tangible property for the term of the lease.

(e) interest in indebtedness -- the term “section 197 intangible” does not include an interest in indebtedness in existence when the interest was acquired. This exception applies to any interest whether as a debtor or a creditor. See Section 197(e)(5)(B); Treas. Reg. § 1.197-2(c)(9).

[3] The proposed regulations used “125 percent.” No reason was given for the change in numbers, and presumably no change was intended.

(f) professional sports franchises -- the term "section 197 intangible" does not include a franchise to engage in professional baseball, basketball, football, or other professional sport, and any item acquired in connection with such franchise. Depreciation of such interests remains subject to existing law (i.e., section 1056). See Section 197(e)(6); Treas. Reg. § 1.197-2(c)(10). Cf. TAM 200244019 (June 19, 2002) (broadcast rights acquired by the taxpayer in connection with the acquisition of a professional sports team excluded from amortization under section 197).

(g) transaction costs in a tax-free reorganization -- the term "section 197 intangible" does not include the amount of any fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C of the Code. The legislative history provides, "This provision addresses a concern that some taxpayers might attempt to contend that [section 197] applies to any such amounts that may be required to be capitalized under present law but that do not relate to any asset with a readily identifiable useful life. The exception is provided solely to clarify that section 197 is not to be construed to provide [15-year] amortization for any such amounts." Conference Report, at 683. See Section 197(e)(8); Treas. Reg. § 1.197-2(c)(12).

(h) various interests that are not acquired as part of a trade or business, including:

i) any computer software (other than off-the-shelf computer software or software acquired for internal use) that is not acquired as part of a trade or business is not a "section 197 intangible;"[4]

[4] The amortization period for any depreciable computer software that is not a section 197 intangible is 36 months, beginning with the month that the computer software is placed in service. The cost of any computer software that is currently deductible continues to be taken into account in this manner. Conference Report, at 680; see Preamble, 65 Fed. Reg. at 3,821; see also FSA 200207006 (Nov. 1, 2001) (distinguishing between software that qualifies as a section 197 intangible and software that does not, which is amortized over 36 months).

ii) any interest in a film, sound recording, video tape, book, or similar property -- this category includes licenses to use such items;

iii) any contractual right to receive tangible property or services;

iv) any interest in a patent or copyright; and

v) any right to service mortgage indebtedness secured by residential real property -- such rights are subject to a nine-year amortization period.

d. Self-created intangibles

(1) Section 197 does not govern any "section 197 intangible" that is created by the taxpayer if it is not created in connection with a transaction that involves the acquisition of assets which constitute a trade or business. See Section 197(c)(2); Treas. Reg. § 1.197-2(d)(2). See also PLR 200243002 (July 16, 2002) (discussing the characterization of self-created goodwill sold in a number of section 338 and 1060 transactions and ruling as to the selling party that the goodwill was a capital asset under section 1221, rather than an amortizable section 197 intangible).

(2) For purposes of this exception, an intangible created by another party under a contract with the taxpayer will be considered a "self-created" intangible. However, the exception for "self-created intangibles" does not apply to any of the following:

(a) the entering into (or renewal of) a contract for the use of a section 197 intangible;

(b) any license, permit, or other right that is granted by a governmental unit or agency;

(c) any covenant not to compete (or similar arrangement); and

(d) any franchise, trademark, or trade name. See Treas. Reg. § 1.197-2(d)(2).

C. Special Rules

1. Determination of Basis

a. The adjusted basis of an amortizable section 197 intangible generally is determined under the current law principles that apply to asset acquisitions (i.e., under the rules of sections 1060 and 338(b)(5) previously discussed).

b. Thus, if a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the intangible is increased as of the beginning of the month that the contingent amount is paid or incurred, and is amortized over the remaining months of the amortization period that applies to the intangible. Conference Report, at 685.

c. Recent regulations clarify that section 197(f)(5) determines the basis of an amortizable section 197 intangible asset with respect to insurance contracts acquired in an assumption reinsurance transaction. Under the proposed regulations, the basis of such an intangible is the excess of the amount paid or incurred by the acquirer (e.g., reinsurer) for the relevant insurance contract or group of insurance contracts over the amount, if any, required to be capitalized under section 848 in connection with the acquisition. Prop. Treas. Reg. § 1.197-2(g)(5). In 2006, the Service issued final and temporary regulations that substantially adopt the proposed regulations. See T.D. 9257 (Apr. 10, 2006), 71 F.R. 17990-18004.

2. Dispositions

a. A section 197 intangible will not be considered to be disposed of (or to be worthless) if it was acquired in a transaction with other section 197 intangible assets until all such intangibles that were acquired in the same transaction are disposed of. See Treas. Reg. § 1.197-2(g)(1)(i)(A).

b. For purposes of the disposition rules, all persons treated as a single taxpayer under section 41(f)(1) are treated as a single taxpayer. The result of a disposition of a section 197 intangible covered by this rule is as follows:

(1) no loss is recognized on the disposition of the single intangible;

(2) the adjusted bases of the retained intangibles are proportionately increased by the amount of loss not recognized; and

(3) a covenant not to compete will not be deemed to have been disposed of or to have become worthless prior to the disposition of the business in connection with which the covenant was obtained.

(4) Final regulations provide guidance on the ability of a taxpayer to recover basis and the proper method for computing loss on the disposition on an amortizable section 197 intangible relating to insurance contracts. See Treas. Reg. § 1.197-2(g)(5)(ii)(A).

(a) The Service felt it necessary to provide such guidance because subchapter L generally does not provide for the computation of an amount realized on the disposition of insurance contracts.

(b) Accordingly, under the temporary regulations, basis recovery is permitted on the disposition of an amortizable section 197 intangible relating to insurance contracts when sufficient economic rights related to the insurance contracts giving rise to the application of section 197 have been transferred. Treas. Reg. § 1.197-2(g)(5)(ii)(A)(2).

(c) The temporary regulations also provide that the amount of loss recognized on the disposition of an amortizable section 197 intangible relating to insurance contracts is equal to the amount, if any, by which the adjusted basis of the intangible immediately prior to the disposition exceeds the amount, if any, that the taxpayer receives from another person for the right to future income on the insurance contacts. Treas. Reg. § 1.197-2(g)(5)(ii)(B)

3. Nonrecognition Transfers

a. If a section 197 intangible is acquired in a nonrecognition transaction (under sections 332, 351, 361, 721, 731, 1031, or 1033), the transferee generally stands in the shoes of the transferor to the extent of the transferor's basis for purposes of section 197.

b. Section 197 would apply to the extent that there is a step-up in basis in connection with the nonrecognition transaction (e.g., a section 351 transaction with boot).

c. The section 197 regulations state that the transfer of an amortizable section 197 intangible in a section 351 or section 721 transaction, when other amortizable section 197 intangibles acquired in the same acquisition of a trade or business are retained by the taxpayer, followed by a sale of the stock or partnership interest received, will not avoid the application of the loss disallowance provisions described in II.C.2. above to the extent the adjusted basis of the transferred intangible at the time of the sale exceeds its fair market value at that time. Treas. Reg. § 1.197-2(g)(1)(B).

4. Partnership Transactions

a. A transaction in which a taxpayer acquires an interest in a partnership that owns an intangible will be treated as an acquisition of a section 197 intangible only to the extent that the taxpayer obtains a basis greater than the partnership's basis for the asset. Conference Report, at 686; see also, section 197(f)(9)(E).

b. The acquiring partner will step into the shoes of the selling partner as to the remaining pre-existing basis in any such intangible owned by the partnership.

c. If a section 197 intangible is transferred or is deemed to be transferred due to a termination under section 708(b)(1)(B), the terminated partnership is treated as the transferor and the new partnership is treated as the transferee with respect to any section 197 intangible held by the terminated partnership immediately preceding the termination. Treas. Reg. § 1.197-2(g)(2)(iv).

d. Finalized section 197 regulations provide rules for the application of sections 704(c), 732(d), 734(b), and 743(b) to section 197. Treas. Reg. § 1.197-2(g)(3), (4); see also Treas. Reg. § 1.197-2(k) exs. 13-19.

(1) In general, any increase in the adjusted basis of a section 197 intangible under sections 732(b) or 732(d) (relating to a partner’s basis in distributed property), section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property after a distribution of property to a partner), or section 743(b) (relating to the optional adjustment to the basis of partnership property after the transfer of a partnership interest) is treated as a separate section 197 intangible acquired at the time of the

transaction causing the basis increase. Treas. Reg. § 1.197-2(g)(3).

(2) To the extent that an intangible was an amortizable section 197 intangible in the hands of the contributing partner, a partnership may make allocations of amortization deductions with respect to the intangible to all its partners under any of the permissible methods described in the regulations under section 704(c). Treas. Reg. §§ 1.197-2(g)(4), 1.704-3 (describing the traditional method, the traditional method with curative allocations, and the remedial allocation method); see also Rev. Rul. 2004-49, 2004-21 I.R.B. 1 (ruling that, when a partnership revalues a section 197 intangible pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f) that is amortizable in the hands of the partnership, the partnership may make allocations (i.e., "reverse section 704(c) allocations") of amortization deductions with respect to the built-in gain or loss from the revaluation to all of its partners under any of the permissible methods described in Treas. Reg. § 1.704-3).

(3) To the extent that an intangible was not an amortizable section 197 intangible in the hands of the contributing partner, the intangible is not amortizable under section 197 by the partnership. However, if a partner contributes a section 197 intangible to a partnership and the partnership adopts the remedial allocation method for making section 704(c) allocations of amortization deductions, the partnership generally may make remedial allocations of amortization deductions with respect to the contributed section 197 intangible in accordance with Treas. Reg. § 1.704-3(d). Treas. Reg. § 1.197-2(g)(4); see also Rev. Rul. 2004-49, 2004-21 I.R.B. 1 (confirming that the same rules apply to reverse section 704(c) allocations with respect to intangibles that were not amortizable in the hands of the partnership at the time of a revaluation of partnership assets under Treas. Reg. § 1.704-1(b)(2)(iv)(f)).

5. Depreciable Character

a. A section 197 intangible is deemed to be property subject to depreciation under section 167. Thus, a section 197 intangible is not a capital asset under section 1221 and is subject to the recharacterization rules of sections 1239 and 1245.

b. An amortizable section 197 intangible that is held for more than one year generally qualifies as section 1231 property.

6. Anti-Churning Rules

a. Extensive anti-churning rules are intended to prevent pre-existing non-amortizable intangibles from being converted into amortizable section 197 intangibles in transactions where the user does not change or where related parties are involved. Unlike the proposed regulations, the final regulations expressly state this purpose of the anti-churning rules and provide that the rules are to be applied in a manner that carries out their purpose. Treas. Reg. § 1.197-2(h)(1)(ii). Broad anti-abuse rules disqualify any asset acquired in a transaction designed to avoid the anti-churning rules. See section 197(f)(9)(F); Treas. Reg. § 1.197-2(h)(11), -2(j).

b. An amortization deduction under section 197 may not be taken for an asset that, but for section 197, would not be amortizable (i.e., a "section 197(f)(9) intangible"[5]) if (1) it was acquired after August 10, 1993, and (2) either (i) the taxpayer or a related person held or used the intangible (or an interest therein) at any time on or after July 25, 1991 and on or before August 10, 1993 (the "Interim Period"), (ii) the intangible was acquired from a person that held the intangible at any time during the Interim Period and, as part of the transaction, the user of the intangible does not change, or (iii) the taxpayer grants the right to use the intangible to a person that held or used the intangible at any time during the Interim Period (or a person related to that person) and the grant of the right to use the intangible and the acquisition of the intangible by the taxpayer are part of a series of related transactions. See Treas. Reg. § 1.197-2(h)(2).

c. The anti-churning rules do not apply to deductions otherwise allowable under section 1253(d) or Treas. Reg. § 1.162-11. See Treas. Reg. § 1.197-2(h)(3).

d. The anti-churning rules do not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a). Treas. Reg. § 1.197-2(h)(5)(i).

e. For purposes of the anti-churning rules, a person is related to another person if (i) the person bears a relationship to that person which would be specified in section 267(b) (and, by substitution, section 267(f)(1)) or 707(b)(1) if such sections were amended by substituting 20 percent for 50 percent, or (ii) the persons are

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[5] The most common types of section 197(f)(9) intangibles are goodwill and going concern value. Treas. Reg. § 1.197-2(h)(1)(i).

engaged in trades or businesses under common control. See Treas. Reg. § 1.197-2(h)(6).

(1) In the case of a single transaction, a person is treated as related to another person if such relationship exists immediately before or after the acquisition of the intangible. Treas. Reg. § 1.197-2(h)(6)(ii)(A).

(a) The regulations provide that in the case of a series of related transactions (or a series of transactions that together comprise a qualified stock purchase under section 338), the relationship is tested immediately before the earliest transaction and immediately after the last such transaction. Treas. Reg. § 1.197-2(h)(6)(ii)(B); Preamble, 65 Fed. Reg. at 3,824.

i) Assume that instead of merging T into P, P purchases an additional 56 percent of the stock of T within one month of P's acquisition of 25 percent of the stock of T (for a total of 81 percent ownership), and makes a section 338(g) election to treat the stock purchases as asset acquisitions. The anti-churning rules would not apply.

ii) The final regulations also contain an example clarifying that a relationship created as part of a public offering is disregarded. Assume that Corp X forms a new corporation, Y, and transfers an unwanted business (including an unamortizable section 197 intangible) ("Target") to Y. Prior to the transfer, X and an underwriter entered into a binding agreement pursuant to which the underwriter would purchase 85 percent of the Y common stock from X and sell those shares in a public offering. When the public offering closes, X and Y make a section 338(h)(10) election for Target. Because the relationship between old Target and new Target is tested immediately before the first transaction (the formation of Y) and immediately after the last transaction(the public offering), old Target and new Target will not be considered related for purposes

of the anti-churning rules. Treas. Reg. § 1.197-2(k), Ex.24.

(b) The final regulations also provide that certain transitory relationships are disregarded for purposes of determining whether persons are related. If a person acquires an intangible in a series of related transactions in which the person acquires stock of a corporation representing 80 percent (measured by vote and value) in a taxable transaction followed by a liquidation under section 331, any relationship created as part of such series of related transactions is disregarded in determining whether any person is related to such acquired corporation immediately after the last transaction. Treas. Reg. § 1.197-2(h)(6)(iii).

i) Assume, for example, that individual A owns all of the stock of T. A sells 60 percent of the T stock to Corp X and 40 percent to Corp Y. In a related transaction, X and Y liquidate T. Because neither X nor Y acquired 80 percent of the T stock, the relationship created is not disregarded, and the anti-churning rules apply.

ii) However, if all of the T stock had been acquired by a partnership owned by X and Y, presumably the relationship would be disregarded, and the anti-churning rules would not apply.

f. In order to determine whether the anti-churning rules apply with respect to any increase in basis of partnership property under section 732, 734, or 743, determinations are made at the partner level and each partner is to be treated as having owned or used such partner's proportionate share of the partnership property. See section 197(f)(9)(E); Treas. Reg. § 1.197-2(h)(12)(i).

(1) The regulations provide that the anti-churning rules do not apply to an increase in basis of partnership property under section 732(d) or section 743(b) if the distributee partner, (or acquiring partner) was not related to the person transferring the partnership interest. See Treas. Reg. § 1.197-2(h)(12)(iii), (v).

(a) Query whether the anti-churning rules do not apply to a section 743(b) basis increase if the acquirer owns more than a 20-percent interest in the partnership prior to the acquisition, and, if the anti-churning rules do not apply, whether such acquiring partner could be allowed to amortize goodwill such acquiring partner originally contributed to the partnership.

(b) Discussions with Service officials indicate that an acquiring partner that already owns a greater than 20 percent interest in the partnership should be allowed to amortize all goodwill attributable to a section 743(b) adjustment, even if some of that goodwill was originally unamortizable and contributed by such acquiring partner to the partnership. However, such discussions also indicate that if the contribution of such unamortizable goodwill and the acquisition that results in the section 743(b) adjustment are part of a series of related transactions, the anti-churning rules will apply to deny amortization with respect to the goodwill contributed by the acquiring partner. It is unclear, however, how the regulations can be read to provide such an exception to the general rule that an acquiring partner may amortize goodwill attributable to a section 743(b) adjustment if such partner is not related to the selling partner.

(2) The Service issued proposed regulations on the treatment of basis adjustments under sections 732(b) and 734(b) in January 2000. In November 2000, the Service finalized the proposed regulations, with some modifications. T.D. 8907 (effective November 20, 2000).

(a) For purposes of applying the anti-churning rules to basis adjustments under section 732(b), the final regulations provide that the distributee partner is deemed to acquire the distributed intangible directly from the continuing partners. Treas. Reg. § 1.197-2(h)(12)(ii). The regulations contain a favorable stacking rule that treats the distributee partner as acquiring the intangible first from the continuing partners for whom transfers would not be subject to the anti-churning rules. Id.; Treas. Reg. § 1.97-2(h)(12)(ii); Preamble, T.D. 8907.

(b) Under the final regulations, the anti-churning rules generally do not apply to a continuing partner's share of a section 734(b) basis increase. Treas. Reg. § 1.197-2(h)(12)(iv).

i) A partner's share of a section 734(b) basis increase is equal to:

a) The total basis increase under section 734(b) allocable to the intangible, multiplied by:

b) the amount of the continuing partner's post-distribution capital account, <u>over</u> the total amount of the post-distribution capital accounts of all continuing partners. Capital accounts are determined immediately after the distribution in accordance with the capital accounting rules of Treas. Reg. § 1.704-1(b)(2)(iv).

ii) NOTE: The final regulations substantially changed the second part of this calculation. The proposed regulations focused on the unrealized appreciation from the intangible that would have been allocated to the continuing partner if the partnership had sold the intangible immediately before the distribution. That yielded incorrect results, because in many situations, all of the unrealized appreciation would be allocated to the noncontinuing partner.

(c) If a distribution that results in a section 734(b) adjustment is undertaken as part of a series of related transactions that include a contribution of the intangible to the partnership by the continuing partner, the anti-churning rules will apply to deny amortization for the continuing partner with respect to the 734(b) adjustment to the contributed intangible. Treas. Reg. § 1.197-2(h)(12)(iv)(E)(2).

(3) The final regulations address the situation where a partner is or becomes a user of a partnership intangible. If an “anti-churning partner” (or a related person other than the partnership) becomes (or remains) a direct user of an

intangible that is treated as transferred in the transaction (as a result of the partners being treated as having owned their proportionate share of partnership assets), the anti-churning rules apply to the "anti-churning partner's" proportionate share of such intangible. Treas. Reg. § 1.197-2(h)(12)(vi)(A).

(a) The anti-churning partner is generally a partner that acquired an interest in the partnership on or before August 10, 1993 (with respect to intangibles held by the partnership on or before that date), or a partner that acquired an interest in the partnership on or before the date the partnership acquired an intangible subject to the anti-churning rules that is not amortizable with respect to the partnership (with respect to intangibles acquired after August 10, 1993). Treas. Reg. § 1.197-2(h)(12)(vi)(B).

(b) For example, assume that A and B form a partnership. A transfers a non-amortizable section 197 intangible in exchange for a 60-percent interest, and B transfers cash in exchange for a 40-percent interest. A licenses the intangible from the partnership. The partnership makes a section 754 election. A subsequently sells its interest to unrelated C. Ordinarily, the anti-churning rules would not apply to an increase in the basis of partnership property under section 743(b). However, because A is an anti-churning partner that remains a user of the intangible, the anti-churning rules will apply. See Treas. Reg. § 1.197-2(k), ex. 27.

(4) Curative and remedial allocations under section 704(c)

(a) Under the final regulations, where the intangible is amortizable by the contributing partner, the anti-churning rules do not apply to the curative or remedial allocations of amortization deductions with respect to the intangible. Treas. Reg. § 1.197-2(h)(5)(ii)-2(h)(12)(vii)(A); see also Rev. Rul. 2004-49, 2004-21 I.R.B. 1 (ruling that similar rules apply to reverse section 704(c) allocations of amortization deductions attributable to section 197 intangibles that are revalued by a partnership pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f)).

(b) Where the intangible is nonamortizable by the contributing partner, the final regulations do not permit curative allocations. However, the regulations do allow remedial allocations of amortization under section 704(c), unless the partner is related to the partner that contributed the intangible or, as part of a series of related transactions that includes the contribution of the intangible to the partnership, the contributing parter or a related person (other than the partnership) becomes or remains a direct user of the contributed intangible. Treas. Reg. § 1.197-2(h)(12)(vii)(B); see also Rev. Rul. 2004-49, 2004-21 I.R.B. 1 (ruling that similar rules apply to reverse section 704(c) allocations of amortization deductions attributable to section 197 intangibles that are revalued by a partnership pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f)).

(c) NOTE: The final regulations permit remedial allocations and not curative allocations because, under section 704(c), remedial allocations treat the amortizable portion of contributed property like newly purchased property, with a new holding period and determinable allocation of tax items. See Preamble, T.D. 8865. However, curative allocations are not determined as if the applicable property were newly purchased property. Id.

g. The application of the anti-churning rules to any section 197 intangible is limited if (i) the intangible is acquired from a person with generally a less than 50 percent relationship to the acquirer, (ii) the seller elects to recognize gain on the disposition of the intangible, and (iii) the seller agrees, notwithstanding any other provision of the Code, to pay a tax on such gain which, when added to any other Federal income tax imposed on such gain, equals the product of the gain and the highest rate of tax imposed by the Code. Treas. Reg. § 1.197-2(h)(9). The anti-churning rules will continue to apply to such an intangible only to the extent the acquiring taxpayer's basis in the intangible exceeds the gain recognized by the seller. Id.

(1) The proposed regulations did not prescribe procedures for making the election. The final regulations provide such guidance. Treas. Reg. § 1.197-2(h)(9)(iii).

h. A section 197(f)(9) intangible acquired by a taxpayer after the applicable effective date (i.e., August 10, 1993) does not qualify for amortization under section 197 if one of the principal purposes of the transactions in which it is acquired is to avoid the operation of the anti-churning rules. A transaction will be presumed to have a principal purpose of avoidance if it does not effect a significant change in the ownership or use of the intangible. Treas. Reg. § 1.197-2(h)(11).

i. General Anti-Abuse Rule Any section 197 intangible acquired by a taxpayer from another person is subject to a general anti-abuse rule.

(1) Any section 197 intangible acquired by a taxpayer from another person is subject to a general anti-abuse rule. Under this rule, a section 197 intangible may not be amortized if the taxpayer acquired the intangible in a transaction one of the principal purposes of which is to (i) avoid the effective date of section 197 or (ii) avoid any of the anti-churning rules described above. Section 197(f)(9)(F). The regulations permit the Service to "recast" a transaction as appropriate to achieve tax results consistent with the purpose of section 197. Treas. Reg. § 1.197-2(j).

j. Retroactive Election

(1) Section 13261(g)(2) of OBRA of 1993 generally provides that a taxpayer may elect to apply section 197 to property acquired by the taxpayer after July 25, 1991 and on or before August 10, 1993 (i.e., the retroactive election). Pursuant to this election, a section 197 intangible can be an amortizable section 197 intangible if the taxpayer acquires it after July 25, 1991 (rather than only after August 10, 1993). Furthermore, with respect to property acquired by the taxpayer on or before August 10, 1993, only holding or use of such property on July 25, 1991 shall be taken into account in applying the anti-churning rules. See also Temp. Treas. Reg. § 1.197-1T.

(a) Any increase in the basis of partnership property under section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property) or section 743(b) (relating to the optional adjustment to the basis of partnership property upon a transfer of a partnership interest) will be taken into account under section 197 by a partner as if the increased portion of the basis were attributable to

the partner's acquisition of the underlying partnership property on the date the distribution or transfer occurs. For example, if a section 754 election is in effect and, as a result of its acquisition of a partnership interest, a taxpayer obtains an increased basis in an intangible held through the partnership, the increased portion of the basis in the intangible will be treated as an intangible asset newly acquired by that taxpayer on the date of the transaction. Temp. Treas. Reg. § 1.197-1T(b)(8).

(b) If property is transferred in a nonrecognition transaction (e.g., section 721 or section 731) and the property was subject to a retroactive election in the hands of the transferor, the property remains subject to the retroactive election with respect to so much of its adjusted basis in the hands of the transferee as does not exceed its adjusted basis in the hands of the transferor. However, the transferee is not required to make a retroactive election for any other property it owns. Temp. Treas. Reg. § 1.197-1T(c)(1)(iv)(A).

(c) If property is transferred in a nonrecognition transaction and the transferee makes a retroactive election, the transferor is not required to apply the retroactive election rules to any of its property. Temp. Treas. Reg. § 1.197-1T(c)(1)(iv)(B).

(d) For purposes of determining whether a taxpayer "acquired" property after July 25, 1991 and on or before August 10, 1993, property (other than exchanged basis property) acquired in a nonrecognition transaction generally is treated as acquired when the transferor acquired (or was treated as acquiring) the property (or predecessor property). However, if the adjusted basis of the property in the hands of the transferee exceeds the adjusted basis of the property in the hands of the transferor, the property is treated as acquired at the time of the transfer to the extent of that excess basis. Temp. Treas. Reg. § 1.197-1T(c)(1)(iv)(E).

(e) In case of an intangible held by a partnership that is eligible for a retroactive election, the partnership must make the election generally. However, in case of an increase in basis of such an intangible due to a

section 754 election that is treated as a newly acquired intangible by a particular partner under Temp. Treas. Reg. § 1.197-1T(b)(8), only that partner can make the election. Temp. Treas. Reg. § 1.197-1T(c)(2). Notice 94-41, 1994-1 C.B. 353, changes this rules with respect to section 734(b) basis adjustments. Only the partnership is eligible to make a retroactive election with respect to a basis increase under section 734(b).

(f) In general, a retroactive election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the taxable year that includes August 10, 1993. If, however, the taxpayer's original Federal income tax return for the taxable year that includes August 10, 1993, is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994. Temp. Treas. Reg. § 1.197-1T(c)(3)(i).

(2) NOTE: The Small Business Job Protection Act of 1996 ("Small Business Act"), Pub. L. No. 104-188, § 1703(l), 110 Stat. 1755, 1877, clarified that, if a taxpayer and related parties make an election to apply the amortization rules to acquisitions after July 25, 1991, "the anti-churning rules do not apply when property acquired from an unrelated party after July 25, 1991 (and not subject to the anti-churning rules in the hands of the acquiring party) is transferred to a taxpayer related to the acquirer [after August 10, 1993]." H.Rep.No. 104-586 (May 23, 1996); see also Small Business Act, § 1703(l).

(3) International trademarks reacquired by a corporation are not subject to the anti-churning rules and are amortizable intangibles. See P.L.R. 9630015 (Apr. 26, 1996) (ruling that trademarks sold to an unrelated buyer and later reacquired from such buyer's subsidiary, after the seller had itself been acquired by the buyer were amortizable intangibles).

D. Effective Date

1. In general, section 197 applies to property acquired after August 10, 1993, the date of enactment.

2. However, a taxpayer may elect for section 197 not to apply to any acquisition of property after the effective date if

   a. the acquisition is pursuant to a written binding contract in effect on August 10, 1993 and at all times thereafter (the "binding written contract exception"),

   b. the taxpayer does not elect to have section 197 apply to property acquired after July 25, 1991, and

   c. the taxpayer makes an election to have the binding written contract exception apply with respect to the acquisition. 1993 Act, section 13261(g)(3)(A).

3. Alternatively, a taxpayer may elect to apply section 197 to all property acquired by the taxpayer after July 25, 1991 (the "retroactive election").

   a. The retroactive election is an "all or nothing election," and applies to all property acquired by that taxpayer (and any other taxpayer under common control) after July 25, 1991.

   b. The committee reports indicate that the Treasury Department will require the election to be made on the return of the taxpayer for the taxable year that includes August 10, 1993.

4. On March 10, 1994, Treasury issued temporary regulations under section 197 that provide rules for making the elections in accordance with the binding written contract exception and the retroactive election. These regulations are discussed below.

E. Regulatory Guidance

The Secretary is given broad power to issue regulations "as may be appropriate to prevent avoidance of the purposes of this section through related persons or otherwise." Section 197(g).

1. In T.D. 8528, dated March 10, 1994, Treasury issued temporary regulations which set forth the rules for making the binding written contract exception and the retroactive election previously discussed.

   a. The binding written contract exception

      (1) In general, if a taxpayer

         (a) acquires property pursuant to a binding written contract in effect on August 10, 1993 and at all times thereafter, and

(b) makes the election under the binding written contract exception, the law in effect prior to the enactment of section 197 will apply to all property acquired pursuant to the contract. Temp. Treas. Reg. § 1.197-1T(d)(1).

(2) A separate binding written contract election must be made with respect to each eligible acquisition to which the pre-1993 Act law is to apply. Id.

(3) The time and manner for making the binding written contract election is the same as for making the retroactive election. Temp. Treas. Reg. § 1.197-1T(d)(2).

b. The retroactive election

(1) In general, if a taxpayer makes the retroactive election, section 197 will apply to all the taxpayer's "transition period property." Temp. Treas. Reg. § 1.197-1T(c)(1)(i). The term "transition period property" is defined as any property that was acquired by the taxpayer after July 25, 1991, and on or before August 10, 1993. Temp. Treas. Reg. § 1.197-1T(b)(2).

(2) If a taxpayer makes the retroactive election, section 197 applies to each taxpayer that is under common control of the electing taxpayer (as if the taxpayer under common control of electing taxpayer had made the election). Temp. Treas. Reg. § 1.197-1T(c)(1)(ii).

(3) A taxpayer is considered to be under "common control" with the electing taxpayer if, at any time after August 2, 1993, and on or before the date on which the electing taxpayer files the return which includes the election, the two taxpayers would be treated as a single taxpayer under section 41(f)(1)(A) or (B). Temp. Treas. Reg. § 1.197-1T(b)(6).

(a) A taxpayer making a retroactive election must notify each member that is under common control with such taxpayer of its retroactive election. Notice 94-90, 1994-2 C.B. 561. Such notifications must be in writing.

(b) A retroactive election binds all taxpayers under common control, whether domestic or foreign. If a foreign corporation files a U.S. income tax return, it may make the retroactive election on such return.

All taxpayers under common control with the foreign corporation, whether domestic or foreign, are bound by such election. Notice 94-90, supra.

(4) A retroactive election by the common parent of a consolidated group also applies to transition period property acquired by a former member while it was a member of the consolidated group, and continues to apply to that property in each subsequent consolidated or separate return year of the former member. Temp. Treas. Reg. § 1.197-1T(c)(1)(iii). However, special rules apply with respect to property of a former member of a consolidated group. See Temp. Treas. Reg. § 1.197-1T(c)(1)(v).

(5) For partnerships, only the partner may make the retroactive election with respect to basis adjustments under § 743(b). However, the partnership must make a retroactive election attributable to an increase in basis under § 734(b). Notice 94-41, 1994-1 C.B. 353.

(6) The retroactive election must be made by the due date (including extensions) of the electing taxpayer's Federal income tax return for the taxable year that includes August 10, 1993. If the taxpayer's original Federal income tax return is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994. Temp. Treas. Reg. § 1.197-1T(c)(3).

(7) The retroactive election may affect tax returns that the electing taxpayer (or another taxpayer that was under common control of the electing taxpayer) filed in previous years.

(a) In the case of the electing taxpayer, the taxpayer is required to amend all previously filed income tax returns to conform the taxpayer's treatment of transition period property to the requirements of section 197. Temp. Treas. Reg. § 1.197-1T(c)(4).

(b) If the taxpayer's election affects another taxpayer's return (i.e., the affected taxpayer was under common control with the electing taxpayer), the electing taxpayer must provide written notification of the retroactive election to the affected taxpayer. Temp. Treas. Reg. § 1.197-1T(c)(3)(ii)(B), -1T(c)(6). The affected taxpayer must then amend all previously filed returns as necessary to conform

its treatment of the transition period property to the rules of section 197. Temp. Treas. Reg. § 1.197-1T(c)(4)(ii)(B).

2. In Announcement 94-92, I.R.B. 1994-28, the Service issued an advance notice of proposed rulemaking in which it invited written comments from the public on six identified issues that should be addressed by proposed regulations under section 197. The identified issues were as follows:

   a. What types of licenses, permits, or other rights should be covered by section 197(d)(1)(D)?

   b. What should constitute "an interest in a trade or business or a substantial portion thereof" for purposes of section 197(d)(1)(E) (covenants not to compete)?

   c. What types of software should be excluded from section 197 treatment?

   d. Under what circumstances should intangibles described in section 197(e)(4)(A), (B), or (C) be considered as not acquired in a transaction (or series of transactions) involving the acquisition of assets constituting a trade or business or a substantial portion thereof?

   e. What rights, whether under contract or granted by a governmental unit or agency or instrumentality thereof, should be excluded from section 197 treatment?

   f. What specific rules are needed to clarify the application of the anti-churning rules?

   g. For comments under Announcement 94-92, see Enrolled Agents Comment on Amortization Rules for Intangibles, 94 TNT 175-53 (Sept. 6, 1994); Software Publishers Say Exception to Intangibles Amortization Rules Should focus on Transfers of Goodwill, 94 TNT 171-27 (Aug. 31, 1994).

3. On January 16, 1997, the Service issued proposed regulations under sections 167 and 197. On January 20, 2000, the Service issued final regulations. These regulations provide guidance on the interpretation of the section 197 rules. The regulations are generally effective with respect to property acquired on or after January 25, 2000. Treas. Reg. § 1.197-2(l)(1).

F. Comments and Observations

1. Section 197 generally applies to all acquired "section 197 assets," whether or not they are acquired as part of a trade or business. Conference Report, at 673. Thus, although the provision is typically associated with the acquisition of a trade or business, its application is much broader. For example, the purchase of a single mailing list would result in the application of section 197 if it is held in connection with the conduct of a trade or business.

2. Generally, the acquisition of stock in a corporation (where no section 338 election is made) or an interest in a partnership does not trigger section 197.

   a. However, section 197 does apply to the acquisition of a partnership interest to the extent the purchaser receives an increased basis in a section 197 intangible held by the partnership as a result of the acquisition.

   b. Thus, if a partnership owns a section 197 intangible and has made an election under section 754, the amount of the section 743(b) basis step-up attributable to the section 754 election is treated as a section 197 intangible, which the purchaser amortizes pursuant to section 197. Conference Report, at 686-87.

   c. Under the regulations, any increase in the basis of partnership property under section 734(b) or 743(b) treated as a separate section 197 intangible, which is treated as having been acquired at the time of the transaction causing the basis increase. See Treas. Reg. § 1.197-2(g)(3).

   d. If a covenant not to compete is entered into in connection with the acquisition of stock or a partnership interest, the covenant is considered a section 197 intangible if the corporation or partnership is engaged in a trade or business. Conference Report, at 677.

   e. If the former owner of a business agrees to continue to perform services that benefit the business (i.e., a consulting agreement), the arrangement is considered to have substantially the same effect as a non-competition agreement to the extent that the compensation paid exceeds reasonable compensation. Conference Report, at 677.

3. In the case of licenses, permits, and other governmental rights, the legislative history provides that the issuance or renewal of the license, permit or other right by a governmental agency or instrumentality is

considered an "acquisition" for purposes of section 197. Conference Report, at 676-77.

G. Ongoing Disputes Involving Intangibles

1. The enactment of section 197 did little to resolve the large number of ongoing disputes involving the proper tax treatment of acquired intangible assets.

   a. In an August 1991 report prepared by the United States General Accounting Office (GAO) titled "Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets," (GAO/GGD-91-88) (the "GAO Report"), the GAO's analysis of the IRS' 1989 data from all open cases under examination, appeals or litigation identified:

      (1) 2,166 open audit issues involving 175 different types of intangible assets,

      (2) having a claimed value of over $23 billion. GAO Report, at 22.

   b. In about 70 percent of the cases, the Service had challenged taxpayers primarily about the classification of assets as intangible assets rather than goodwill. In the remainder of the cases, the dispute was over value and/or useful life. In total, the Service had proposed adjustments of over $8 billion for these cases. Id.

   c. The legislative history to section 197 includes the following instruction:

      The conferees reiterate the intended purpose of the provision, as stated in both the House and Senate reports, to simplify the law regarding the amortization of intangibles. The severe backlog of cases in audit and litigation is a matter of great concern to the conferees; and any principles established in such cases will no longer have precedential value due to the provision contained in the conference agreement. Therefore, the conferees urge the Internal Revenue Service in the strongest possible terms to expedite the settlement of cases under present law. In considering settlements and establishing procedures for handling existing controversies in an expedient and balanced manner, the conferees strongly encourage the Internal Revenue Service to take into account the principles of the bill so as to produce consistent results for similarly situated taxpayers. However, no inference is intended that any deduction should be allowed in these cases for assets that are not amortizable under present law. Conference Report, at 696.

2. On February 9, 1994, the IRS National Office initiated a comprehensive plan that can be used in settling ongoing disputes involving acquisitions made before July 25, 1991. This IRS "settlement initiative" includes the following provisions:

   a. General terms -- Taxpayers who accept the IRS settlement offer must reduce the basis of the claimed amortizable intangibles by the greater of (i) 15 percent of the bases of the intangibles, or (ii) a 50-percent cost recovery adjustment. These adjustments are made on an acquisition-by-acquisition basis.

      (1) The 15-percent reduction is the minimum concession required under the settlement initiative and is applicable to all intangibles for which amortization is claimed. The 15-percent reduction applies regardless of how much the taxpayer allocated to nonamortizable intangibles (i.e., goodwill);

      (2) The 50-percent cost recovery adjustment is the function of (i) the percentage of intangible value amortized in relation to total intangible value (expressed in terms of a recovery amount percentage), and (ii) the time value of amortization deductions, using a 5.5-percent annual discount rate.

      (3) Example: Taxpayer reports a total value for intangibles of \$2 million on his tax return. Of that, \$400,000 is allocated to goodwill/going concern value, \$1 million is allocated to customer lists (amortized on a 7-year, straight-line basis), and \$600,000 to assembled workforce (amortized over 4 years). Under the settlement initiative, the taxpayer first calculates the 15-percent basis reduction of \$240,000 (i.e., \$1,600,000 x .15). Next, the taxpayer calculates the 50-percent cost recovery adjustment as follows:

         (a) Weighted average life:

Customer list	\$1,000,000 x 7 years =	\$7,000,000
Workforce	\$ 600,000 x 3 years =	\$1,800,000
	\$1,600,000	\$8,800,000

Weighted Average life is \$8,800,000/\$1,600,000 = 5.5 years;

         (b) The 50-percent cost recovery table:

5.5 years yields a nonamortizable percentage of 40.7 percent;

         (c) Tentative Basis Adjustment:

$2 million intangible value x 40.7 percent = $814,000;

(d) Required Basis adjustment:

$814,000 - $400,000 nonamortizable value = $414,000;

The 50-percent cost recovery adjustment is greater than the 15-percent basis adjustment. Therefore, $414,000 is the required concession. Using this concession, the basis and amortization adjustments for each type of intangible are computed. Specifically, the computed basis adjustment is allocated to the claimed amortizable intangibles in proportion to their relative basis, and the basis of goodwill/going concern value is correspondingly increased:

Intangible	Original Basis	Adjustment	Revised Basis
Goodwill/ going concern value	$ 400,000	$ 414,000	$ 814,000
Customer list	1,000,000	(258,750)	741,250
Assembled workforce	600,000	(155,250)	444,740
	$2,000,000		$2,000,000

(4) The recomputed basis of an intangible may be amortized using the method used on the taxpayer's original return. However, if such method is other than straight-line, the taxpayer must determine the straight-line useful life equivalent to properly compute the 50-percent cost recovery adjustment to basis.

(5) In lieu of the basis adjustment determined under the above test, a taxpayer may opt for lengthening the weighted average useful life of the amortizable intangibles as long as the result under this approach yields the same present value as that yielded under the basis adjustment. The method for calculating the appropriate extended life adjustment is provided by the Service.

(6) If closed years are affected by a settlement, a taxpayer must make up for any excess deductions in those closed years by reducing amortization deductions in open years. Any such reduction is to be taken in the earliest open year. If excess

deductions for closed years remain when the particular intangible's basis reaches zero, the remaining excess is to be applied against any amortization deductions for other amortizable intangibles acquired in the same transaction.

(7) Additional issues relevant to the settlement initiative include the facts that (i) all preliminary issues (e.g., allocation between tangible and intangible assets) must be resolved before computing the settlement offer, and (ii) consolidated groups must accept the settlement initiative for all acquisitions for which an intangible issue was raised in pre-April 1, 1994 audits.

b. Procedural Aspects

(1) Situations where the settlement initiative is not available:

(a) for acquisitions of intangibles after July 25, 1991;

(b) for amended returns or refund claims where deductions for the amortization of intangibles relative to those claimed on the original return are increased;

(c) in cases where the Service's field personnel satisfies the National Office cross-functional committee that an offer should be withheld (e.g., in situations where the Service has spent large amounts of money in developing a case).

(2) Settlement offers were permitted to be made starting April 1, 1994. The taxpayer has ninety days from the date of the offer to accept or reject the offer in writing, but the offer may be extended for an additional 90 days for good cause. Once rejected, either in writing or by silence, the Service will not extend the offer again.

(3) Once an offer is made a taxpayer may either accept or reject it. Acceptance may not be contingent on the settlement of other issues. Additionally, the offer must be accepted for all acquisitions in issue. Upon acceptance, the Service and taxpayer will enter into a specific matters closing agreement (see Form 9006). Upon rejection of an offer, the case is handled under normal procedures.

III. EXAMPLES OF THE APPLICATION OF SECTION 197

A. **Example 1 -- "Applicable Asset Acquisition"**

A, an individual is involved in retail sales through stores in four different locations. P Corporation wants to acquire one of the four stores to market its own products, which are in competition with the products sold by A. P proposes to pay $500,000 for the land and building which house the store and for A's agreement not to compete in that geographic location. All of the inventory in the acquired store will be retained by A. A has a basis of $100,000 in the land and the building is fully depreciated; assume further that the fair market value of the land is $150,000 and the fair market value of the building is $250,000.

1. Is this an "applicable asset acquisition"?

   a. An applicable asset acquisition is any transfer of assets constituting a trade or business in the hands of the seller <u>or</u> the purchaser, if the purchaser's basis in the acquired assets is determined wholly by reference to the consideration paid for such assets. Section 1060(c).

   b. Regulations define "assets constituting a trade or business" broadly as consisting of any group of assets (i) the use of which would constitute an active trade or business for purposes of section 355, <u>or</u> (ii) to which goodwill or going concern value could under any circumstances attach. Treas. Reg. § 1.1060-1(b)(2).

      (1) For purposes of section 355, a trade or business is a group of activities that includes "every operation that forms a part of, or a step in, the process of earning income or profit." Treas. Reg. § 1.355-3(b)(2)(ii)

      (2) The mere ownership of land and a building may not qualify as a trade or business for purposes of section 355 unless the ownership also involves the provision of significant services with respect to the operation and management of the property. Treas. Reg. § 1.355-3(b)(2).

   c. Covenant not to compete

      (1) Under the temporary regulations in effect prior to January 6, 2000, the presence of a covenant not to compete is a factor in determining whether goodwill or going concern value could attach and, thus, whether there is a transfer of an active trade or business.

      (2) Under both the temporary regulations (effective for asset acquisitions on or after January 6, 2000 and before March 16, 2001) and the final regulations (effective for asset acquisitions on or after March 16, 2001), covenants not to compete should be considered as either intangible assets, the transfer of which would not be a trade or business in the

absence of other assets, or as "related transactions" under Treas. Reg. § 1.1060-1(b)(2)(iii)(C). See Treas. Reg. § 1.1060-1(b)(2)(iii)(A), (C). Thus, under both the temporary and final regulations, covenants not to compete should be a factor in determining whether goodwill or going concern value could attach and, thus, whether there is a transfer of an active trade or business.

d. QUERY: What if the only asset being acquired is land with a prime location? What is the effect of section 197(e)(2) (providing that an interest in land cannot be a section 197 intangible)?

(1) Presumably, the premium value cannot be a section 197 intangible by reason of section 197(e)(2).

(2) Does this mean that a purchase of the land is not an applicable asset acquisition because "goodwill or going concern value could not under any circumstances attach?"

2. Suppose the transaction were restructured so that P contributed $495,000 to S, a newly-formed subsidiary, in return for 90 percent of the stock of S, and A contributed the land and building to S (and entered into a covenant not to compete with S) in return for 10 percent of the stock of S and $445,000.

a. A contribution of property (including cash) in exchange for stock is governed by section 351 if, immediately after the exchange, the transferors own 80 percent of the stock of the transferee corporation.

(1) Even though the cash distributed to A originates with P, the transaction should not be recharacterized as a purchase of assets by P followed by a contribution of those assets to S. Rev. Rul. 68-55, 1968-1 C.B. 140.

(2) A is treated as receiving stock and cash pro rata with respect to each asset (in proportion to the fair market values of the assets). The cash consideration may not be specially allocated to high basis assets. Rev. Rul. 85-164, 1985-2 C.B. 117.

(a) Contrast this rule with that applicable to a sale for cash and notes.

(b) A taxpayer is permitted to treat cash as received in exchange for high basis assets and installment notes as received for low basis assets. Rev. Rul. 68-13, 1968-1 C.B. 195.

b. In the case of a transfer for stock and cash, realized gain is recognized to the extent of the cash received. Section 351(b). The transferee corporation's basis in the assets is equal to the transferor's basis in such assets plus any amount of gain recognized by the transferor as a result of the transaction. Section 362(a).

c. Accordingly, this transaction would not be covered by section 1060(c). Notice that this result applies despite the fact that A recognizes all of the gain inherent in the contributed assets -- just as if section 351 did not apply.

(1) This relieves the parties of their reporting obligations under section 1060.

(2) Potentially, the parties may also be permitted to use an allocation method other than the residual method.

(a) Prior to the enactment of sections 1060 and 197, taxpayers often attempted to use the "second tier allocation" method.

i) Under this method, any consideration in excess of the appraised fair market value (or any shortfall below such fair market value) of assets was allocated among the assets (other than cash) in proportion to such appraised fair market value.

ii) In a case where the consideration was in excess of the appraised fair market value, this approach generally resulted in allocating less consideration to goodwill.

iii) In contrast, in the case of a bargain purchase, the second tier allocation method resulted in a higher allocation to goodwill.

(b) Even prior to the enactment of section 1060, case law had tended to reject the second tier allocation method. See, e.g., Barnes Group Inc. v. United States, 697 F. Supp. 591 (D. Conn. 1988); Banc One Corp. v. Commissioner, 84 T.C. 476 (1985).

(c) Now that goodwill is amortizable over 15 years pursuant to section 197, the residual method may in fact be more advantageous to taxpayers.

d. Even though section 1060 does not apply, S will be able to amortize its full basis in the covenant not to compete under section 197 (assuming S is conducting a trade or business).

(1) Section 197(f)(2) limits the amortizable amount in a section 351 transaction to any additional basis. The covenant had no basis in A's hands; thus, the full amount is amortizable. Alternatively, it is arguable that a covenant not to compete is not subject to section 351 because it relates to an agreement for non-services.

(2) The anti-churning rules of section 197(f)(9) do not apply to covenants not to compete (which were amortizable even under prior law), and in any case, A is not related to S for purposes of the anti-churning rules.

e. NOTE: if the transaction fails to qualify under section 351 (for example, if P disposes of more than 20 percent of the S stock as part of a prearranged plan), then section 1060 will apply.

3. Similarly, section 1060 does not apply to assets acquired by a partnership in a section 721 transaction.

a. Where a contributing partner receives a cash distribution as part of a contribution transaction, section 707 and regulations thereunder may treat the transaction as a "disguised sale."

b. In such case, section 1060 should apply to the extent of the deemed sale.

c. Although section 704(c)(1)(B) and section 737 trigger gain on certain transactions as if there had been a sale of assets, they do not recharacterize such transactions for all purposes of the Code. Accordingly, section 1060 would apparently not apply to gain recognized under section 704(c)(1)(B) or section 737.

4. Where business assets are acquired in redemption of stock or in liquidation, section 1060 arguably should not apply, since the acquirer's basis may be determined under general tax principles by reference to the value of the property received, rather than by reference to the consideration paid by the acquirer. See Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954); section 334(a); section 301(d). However, the Service has taken the position in regulations that section 1060 will apply to such a transaction. Treas. Reg. § 1.1060-1(b)(3), Ex. 3.

a. A distribution of assets in a taxable liquidation appears to be clearly outside the scope of section 1060, because the acquirer's

basis is required to be determined by reference to the value of the property received under section 334(a).

b. Similarly, if the assets are distributed as a dividend, it seems clear that section 1060 does not apply, because the acquirer does not surrender any consideration. See also section 301(b) (amount of distribution is measured by value of property distributed).

B. **Example 2 -- Application of Sections 197 and 1060**

A, an individual, owns all the outstanding stock of Target corporation. As of May 1, 1997, Target owns the following assets:

Asset	Basis	Fair Market Value
Cash	$ 100,000	$ 100,000
Land & Equip.	300,000	400,000
Customer list	-0-	600,000
Goodwill	-0-	300,000
Total	$ 400,000	1,400,000

On May 1, Purchaser agrees to acquire the assets of Target for $1.4 million. In addition, A will execute a non-competition agreement (i.e., a covenant not to compete) that will run for a period of four years. A will be paid $60,000 per year under the non-competition agreement. The first payment is due on May 1, 1997, and the remaining payments are due on May 1 of each successive year. Assume the present fair market value of the non-competition agreement is $240,000, and the customer list has an anticipated useful life of six years.

1. Analysis prior to enactment of section 197

a. Under the residual method, the $1.4 million purchase price would be allocated as follows:

(1) $100,000 to the cash (Class I asset),

(2) $400,000 to the land (Class III asset),

(3) $600,000 to the customer list (Class III asset), and

(4) $300,000 to goodwill (Class IV asset).

b. Purchaser would be entitled to an amortization deduction of:

(1) $160,000 per year for the first four years ($100,000 for the customer list and $60,000 for the non-competition agreement), and

(2) $100,000 per year for years five and six (the customer list).

c. No deduction would be allowed with respect to the $300,000 allocated to goodwill.

2. Analysis under section 197 and the regulations thereunder, prior to the issuance of temporary and final sections 1060 and 338 regulations effective January 6, 2000

The tax consequences are significantly different under section 197, the regulations thereunder, and the sections 1060 and 338 regulations in effect prior to January 6, 2000.

a. The $1.4 million purchase price is allocated as follows:

(1) $100,000 to the cash (Class I asset),

(2) $400,000 to the land (Class III asset),

(3) $600,000 to the customer list (Class IV asset), and

(4) $300,000 to goodwill (Class V asset).

b. Under section 197, Purchaser is entitled to amortization deductions in the amount of $76,000 per year for 15 years, calculated as follows: $40,000 [$600,000/15] attributable to the customer list, $20,000 [$300,000/15] attributable to goodwill, and $16,000 [$240,000/15] attributable to the non-competition agreement.

(1) Under Treas. Reg. §§ 1.197-2(f)(3) and 1.197-2(k), Ex.6, the full contract price of covenants not to compete are amortized ratably over a 15-year period, regardless of when amounts are paid on the contract.

(2) However, note that a taxpayer's basis in a covenant not to compete acquired in an applicable asset acquisition cannot exceed the present fair market value of the taxpayer's rights under the contract. See Temp. Treas. Reg. § 1.1060-1T(e)(1) (effective prior to January 6, 2000). Any amounts paid in excess of the present fair market value of the covenant not to compete are allocated to Class V assets. Id.

c. NOTE: If the assets were acquired prior to February 14, 1997, and no election was made to use the new rules, $100,000 would have

been allocated to the cash (Class I asset), $400,000 would have been allocated to the land (Class III asset), and $900,000 would have been allocated to Class IV assets (as defined prior to the issuance of T.D. 8711).

d. As illustrated by this **example (2)**, section 197 may significantly defer the timing of recovery even though a larger amount may be recoverable. This, of course, will depend on the mix of intangibles that are considered amortizable under existing law and those that are not.

(1) In acquisitions that involve significant amounts of goodwill, section 197 should prove quite beneficial.

(2) In acquisitions involving significant amounts of intangible assets already deemed amortizable under pre-section 197 law, section 197 may extend the amortization period and thus result in a lower present value of recoverable deductions.

3. Analysis under section 197, the regulations thereunder, and the temporary and final section 338 and 1060 regulations generally effective for asset acquisitions on or after January 6, 2000

a. The covenant not to compete under both the new temporary and final section 1060 regulations is treated as an asset transferred as part of the applicable asset acquisition. Treas. Reg. § 1.1060-1(b)(7). Thus, the $240,000 fair market value of the covenant not to compete must be included in the purchase price (i.e., $1.4 million + $240,000 = $1.64 million). Under the final regulations, the $1.64 million purchase price is allocated as follows:

(1) $100,000 to the cash (Class I asset),

(2) $400,000 to the land (Class V asset),

(3) $840,000 to the customer list and the covenant not to compete (Class VI assets), and

(4) $300,000 to goodwill (Class VII asset).

b. Purchaser’s amortization deductions in the amount of $76,000 per year for 15 years, would not change.

4. Effect on parties' acquisition planning

Section 197 significantly affects the parties' acquisition planning.

a. As noted above, prior to the 1986 Act, individual sellers typically preferred a purchase price allocation to goodwill (because it generated capital gain), which was subject to Federal income tax at a maximum rate of 20 percent. Conversely, purchasers typically preferred a purchase price allocation to tangible and amortizable intangible assets, because these amounts generated depreciation and amortization deductions. This natural economic tension generally resulted in allocations based on arm's length negotiations.

b. With the elimination of the preferential treatment of capital gains in the 1986 Act, sellers typically became less concerned with purchase price allocations because the resulting income or gain was subject to tax at the same rate. Purchasers, however, still preferred allocations to tangible and amortizable intangible assets.

(1) The tension that existed prior to 1987 ceased to exist, and acquisitions were structured that maximized the purchaser's depreciation and amortization deductions without adversely affecting the seller's resulting tax liability.

(2) Even when the tax rate on ordinary income increased to 31 percent in 1991, the three percent differential generally was not viewed as significant enough to affect this strategy.

c. The enactment of section 197, coupled with the increase in tax rates on ordinary income to 39.6 percent (creating an 11.6 percent differential between ordinary income and capital gains), creates two new and interesting twists in tax planning strategy.

(1) Assuming the intangible asset being sold is <u>not</u> an amortizable section 197 intangible in the hands of the non-corporate seller (e.g., goodwill that was generated by the seller or acquired prior to the enactment of section 197), the intangible asset should generally be considered a capital asset under section 1221.

(a) As a result, a non-corporate seller typically will prefer a greater allocation to the intangible asset (and a lesser amount to a covenant not to compete), so that a greater portion of the gain is taxed at the lower capital gains rate.

(b) The same analysis applies in the case of a corporate seller (except to the extent the covenant not to compete is treated as a non-corporate asset, in

which case the payments under the covenant escape the corporate-level tax).

(2) If the intangible asset being sold is an amortizable section 197 intangible in the hands of the seller, the asset is not considered a capital asset. Sections 197(f)(7), 1221(2).

(a) The intangible asset is treated as section 1231 property if the seller has held the asset for more than one year. Conference Report, at 688; see Treas. Reg. § 1.197-2(g)(8).

(b) However, if the seller has claimed amortization deductions with respect to the intangible under section 197, the gain that is attributable to the asset is recharacterized as ordinary income. Section 1245(a)(3)(A).

5. Section 338(h)(10) acquisition

Assume that A is a corporation, and A and Purchaser make a joint election under section 338(h)(10).

a. Both section 1060 and section 338(h)(10) allocate basis to assets by class under the residual method.

b. In this example, the two acquisition methods yield the same result. However, the two methods will result in different allocations if Target has more than one business or if it has subsidiaries.

C. **Example 3 -- Section 338(h)(10) Acquisition**

Section 197 will also affect the dynamics in determining whether the parties should elect to treat a stock acquisition as an asset acquisition pursuant to section 338(h)(10). Specifically, the purchaser's cost-benefit analysis must take into account the present value of the longer amortization period for any acquired intangible assets.

1. Background

a. Section 338(h)(10) provides that no gain or loss will be recognized by members of the selling group on the sale of target stock. Rather, target will recognize gain or loss as if it had sold all its assets while included as a member of the selling group.

b. As a result, the tax on target's gain is paid by the selling consolidated group. Such gain can be offset by the losses, if any, of the selling group.

c. The legislative history of section 197 states that the provision applies "to a section 197 intangible that is treated as acquired under section 338 of the Code." Conference Report, at 673. In addition, Treas. Reg. § 1.197-2(e)(5) states that section 197 will apply to section 338 deemed asset purchases if section 197 would have applied to a direct asset purchase.

2. Fact pattern

T Corporation is a wholly-owned subsidiary of S Corporation, with which it files a consolidated return. T's balance sheet at the close of December 31, 1993, is as follows:

Assets		Liabilities	
Cash	$2,000	Accts Payable	$7,000
Inventory	5,000	Other Liabs.	15,000
Accts Receivable	7,000		
Equipment	7,000	Total	22,000
Land	2,000		
Plant	9,000	Equity	10,000
Total	$32,000	Total	$32,000

The S Group has NOLs of $40,000, of which $15,000 are attributable to T. In addition, S's basis in the T stock is $5,000.

a. P Corporation is interested in purchasing T. Assuming that it could acquire the T assets with a FMV basis, P would be willing to pay $65,000, as follows:

Cash	2,000
Inventory	7,000
Accts Receivable	7,000
Equipment	9,000
Land	3,000
Plant	12,000
Goodwill	25,000
Total	65,000

b. Alternatively, if P acquired the T assets with a carryover basis, P would be willing to pay only $52,000 because of the absence of the tax benefits that a stepped-up basis would provide (e.g., higher depreciation, lower gain on the disposition of the assets).

c. If P were also required to assume T's liabilities, it would not pay more than $43,000 with a stepped-up basis ($65,000 less $22,000 of liabilities), or $30,000 with a carryover basis ($52,000 less $22,000 in liabilities).

3. Acquisition with no section 338(h)(10) election

If P agrees to purchase the T stock for $30,000, the results are as follows:

a. Consequences to S

S realizes a gain of $25,000 ($30,000 received less S's basis in the T stock of $5,000). S cannot use the NOLs attributable to T to absorb this gain. Treas. Reg. § 1.1502-11(b). These NOLs, in any event, will be lost because P will succeed to them as the new owner of T (see below). S will be able to shield the entire gain, but it must do so with its own NOLs. Thus, S has no taxable income, cash of $30,000 and no NOLs.

b. Consequences to P

P succeeds to the S Group NOLs that are attributable to T ($15,000). However, these NOLs will be subject to numerous restrictions (e.g., section 382 and the SRLY rules) that may significantly impair their utility. In addition, P will take a basis in the T stock of $30,000 and the inside basis of the T assets will remain $32,000.

4. Section 338(h)(10) acquisition

If P agrees to purchase all the T stock for $43,000 and enters into a section 338(h)(10) election with S, the results are as follows:

a. Consequences to S

S realizes no gain on the sale of the T stock. Rather, T will realize gain equal to the aggregate deemed sales price (“ADSP") less T's inside asset basis. Under these facts, the ADSP is $65,000 ($43,000 grossed-up amount realized on the sale to P of P’s recently purchased stock plus $22,000 of liabilities assumed). (Under these facts, ADSP under the new temporary regulations effective on January 6, 2000 equals MADSP under the old regulations effective prior to January 6, 2000.) T's inside asset basis is $32,000, yielding a gain of $33,000, allocable to the individual assets as follows:

	Amount Rec'd	Adj'd Basis	Gain
Cash	2,000	2,000	
Inventory	7,000	5,000	2,000
Accts Receivable	7,000	7,000	
Equipment	9,000	7,000	2,000
Land	3,000	2,000	1,000
Plant	12,000	9,000	3,000
Goodwill	25,000	0	25,000
Total	65,000	32,000	33,000

Because the deemed sale gain occurs while T is a member of the S group, S may use all of the S Group NOLs in offsetting this amount (with T's NOLs being used up first). Thus, S will be able to shield the entire gain, though its NOLs are reduced from $40,000 to $7,000.

b. Consequences to P

P does not succeed to the NOLs of S which are attributable to T. However, P takes a basis in the T stock of $43,000, and T's aggregate inside basis of its assets increases to $65,000.

5. Section 197 implications

a. By making a section 338(h)(10) election, S is able to increase its post-transaction NOLs and the cash it received. The election clearly makes sense for S.

b. As to P, it was able to increase the basis of the T assets by $33,000, while paying only $13,000 more than if no election had been made.

(1) However, of the $33,000 in increased basis, $25,000 is attributable to goodwill, which under section 197, is recoverable over 15 years. The other $8,000 is attributable to inventory ($2,000), equipment ($2,000), land ($1,000), and plant ($3,000).

(2) In addition, P will forego T's $15,000 in NOLs.

(3) Thus, in order to determine whether P should agree to the section 338(h)(10) election, it would have to weigh the economic cost of making the election (i.e., the present

value of the additional $13,000 of cash and the tax benefit of the forgone $15,000 of T's NOLs (though the NOLs would be subject to the section 382 and SRLY limitations)), with the present value of the increased depreciation and amortization deductions resulting from the increased basis.

D. **Example 4 -- Treatment of Acquisition Costs**

A, an individual, owns all the outstanding stock of Target corporation. As of May 1, 1997, Target owns the following assets:

Asset	Basis	Fair Market Value
Cash	$ 100,000	$ 100,000
Land & Equip.	300,000	400,000
Customer list	-0-	600,000
Goodwill	-0-	300,000
Total	$ 400,000	$1,400,000

On May 1, Purchaser agrees to acquire the assets of Target for $1.4 million. As part of the acquisition, Purchaser incurs $100,000 in legal and other professional fees, and Target incurs $50,000 in similar fees.

1. The cost of acquiring property with a useful life substantially beyond the taxable year is a capital expenditure. INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992) (cost of professional fees incurred by target in connection with a friendly takeover must be capitalized); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970) (cost of professional services incurred by acquirer in connection with an acquisition of stock must be capitalized); Treas. Reg. § 1.263(a)-2(a).

2. As described in **example (1)**, under the residual method required by section 1060, no asset can receive an allocation of consideration greater than its fair market value. Thus, in theory, the Service could treat the acquisition costs as Class VII assets (Class V in the regulations effective prior to January 6, 2000).

   a. Many practitioners believe that a determination of an asset's "fair market value" must include any cost incurred to acquire the asset. The regulations define fair market value of an asset as "its gross fair market value (i.e., fair market value determined without regard to mortgages, liens, pledges or other liabilities)." Treas. Reg. § 1.338-6(a)(2)(i).

b. Other practitioners contend that acquisition costs fall outside the scope of section 1060(a) because the statute refers to the "consideration received," and acquisition costs are paid to a third party. The section 1060 regulations provide, "The purchaser's consideration is the cost of the assets acquired in the applicable asset acquisition. The seller's consideration is the amount realized from the applicable asset acquisition under section 1001(b)." Treas. Reg. § 1.1060-1(c)(1).

(1) However, Form 8594 (Asset Acquisition Statement Under Section 1060), line 3 requires the taxpayer to report the "total sales price." The instructions to line 3 say to "Enter the total consideration transferred for the assets."

(2) The instructions define "consideration" as follows: "The purchaser's consideration is the cost of the assets. The seller's consideration is the amount realized."

(3) Thus, it is unclear whether the "total sales price" reflects acquisition costs.

c. Government lawyers have stated that they believe that acquisition costs fall within the purview of section 1060 and that the fair market value limitation has to be applied.

d. Under both the temporary and final section 1060 regulations, direct acquisition costs (e.g., real estate transfer costs) adjust the amount allocated to an individual asset. Treas. Reg. 1.1060-1(c)(3). However, the treatment of the indirect acquisition costs at issue in **example (4)** is not clear.

3. The enactment of section 197 has done little to clarify this issue. For example, if the Service treats such costs as Class VII assets (or Class V prior to January 6, 2000), would they be eligible for the 15-year amortization?

a. Professional fees and other transaction costs incurred by parties in a transaction in which any portion of the gain or loss is not recognized under sections 351-368 are not section 197 intangibles. Section 197(e)(8).

b. The legislative history explains that "This provision addresses a concern that some taxpayers might attempt to contend that [section 197] applies to any such amounts that may be required to be capitalized under present law but that do not relate to any asset with a readily identifiable useful life [citing INDOPCO]. The exception is provided solely to clarify that section 197 is not to be

construed to provide [15] year amortization for any such amounts." Conference Report, at 683.

c. QUERY: By negative implication, are professional fees and transaction costs incurred by parties in fully taxable transactions section 197 intangibles?

4. Section 263(a) Regulations and Acquisition Costs

(1) On December 31, 2003, final section 263(a) regulations were issued that address the capitalization of costs incurred to "facilitate" an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions. T.D. 9107.

(2) An amount is paid to "facilitate" a transaction if that amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that an amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing the transaction. An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate the exchange. Treas. Reg. § 1.263(a)-5(b)(1).

(3) The Preamble to the proposed 263(a) regulations had previously clarified that the facilitate standard is intended to create a "bright line" rule, which is narrower in scope than a "but-for" standard and more definitive than the "whether and which" test of Revenue Ruling 99-23, 1999-1 C.B. 998.

(4) A modified version of this "bright line" rule was retained under the final regulations in addition to an "inherently facilitative" rule. Treas. Reg. § 1.263(a)-5(e).

i) Thus, an amount paid in the process of investigating or pursuing a transaction facilitates that transaction (and must be capitalized), only if:

a) The payment relates to activities that are performed on or after the earlier of:

i. The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by the acquirer and target; or

ii. The date on which the material terms of the transactions, as tentatively agreed to, are authorized or approved by the board of directors (or other appropriate non corporate governing authority). Treas. Reg. § 1.263(a)-5(e)(1)(i)-(ii); or

b) The payment relates to activities that are "inherently facilitative," regardless of whether the amount paid is for activities performed prior to the date determined under the "bright line" rule above. Treas. Reg. § 1.263(a)-5(e)(2). "Inherently facilitative" activities include:

i. Securing an appraisal, formal written evaluation, or fairness opinion;

ii. Structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure;

iii. Preparing and reviewing the documents that effectuate the transaction;

iv. Obtaining regulatory approval of the transaction;

v. Obtaining shareholder approval of the transaction; or

vi. Conveying property between parties to the transaction. Treas. Reg. § 1.263(a)-5(e)(2)(i)-(vi).

ii) The section 263(a) Regulations provide that the following costs are <u>not</u> costs incurred to facilitate a transaction:

a) Integration costs (i.e. amounts paid to integrate the businesses of the acquirer and target). Treas. Reg. § 1.263(a)-5(c)(6);

b) Employee compensation;

c) Overhead; and

d) De minimis costs (defined as amounts that, in the aggregate, do not exceed $5,000). Treas. Reg. § 1.263(a)-5(d).

(5) Thus, the section 263(a) Regulations indicate that transaction costs incurred to facilitate the acquisition of intangible assets in a taxable asset acquisition, which must involve the acquisition of a trade or business, are capitalized (by both the buyer and seller) to the extent the costs are allocable to such assets, and transaction costs allocable to tangible assets are capitalized to such assets.

(6) In as much as the residual method of allocation is the required method for determining the buyer's basis and the seller's amount realized in applicable asset acquisitions, it seems logical that capitalized transaction costs be allocated in accordance therewith.

5. Section 338(h)(10) acquisition

a. The treatment of acquisition costs raises similar issues in the context of a stock acquisition where the parties make an election under section 338(h)(10).

b. As to the purchaser, prior to January 6, 2000, the inside basis in the acquired assets equals the corporation's AGUB. Treas. Reg. § 1.338(h)(10)-1(e)(5) (effective prior to January 6, 2000).

(1) As noted above, prior to January 6, 2000, the AGUB is defined as the sum of

(a) P's basis in T stock (both recently and nonrecently purchased) (which presumably includes the acquisition costs);

(b) new T's liabilities; and

(c) other relevant items. Treas. Reg. § 1.338(b)-1(c)(1) (effective prior to January 6, 2000).

(2) In defining what constitutes "other relevant items," the regulations in effect prior to January 6, 2000, provided that "other relevant items do not include reductions for acquisition costs incurred by the purchasing corporation in connection with the qualified stock purchase that are capitalized in the basis of recently purchased target stock." Treas. Reg. § 1.338(b)-1(g)(1) (effective prior to January 6, 2000) (emphasis added).

(3) Thus, in this **example (4)**, the purchase price of the assets under the AGUB formula includes acquisition costs. Because the regulations under section 338 require the use of the residual method in allocating the AGUB among the acquired assets, the same issue that exists in section 1060 concerning the treatment of acquisition costs also exists in section 338(h)(10). Treas. Reg. § 1.338(h)(10)-1(e)(5) (effective prior to January 6, 2000); Treas. Reg. § 1.338(b)-2T (effective prior to January 6, 2000).

c. As noted above, the AGUB under both the temporary and final regulations is defined as the sum of

(1) P’s grossed-up basis in recently purchased T stock;

(2) P’s basis in nonrecently purchased T stock; and

(3) new T’s liabilities. Treas. Reg. § 1.338-5(b)(1).

d. Both the temporary and final regulations include the acquisition costs incurred by P in determining grossed-up basis in P’s recently purchased T stock. Treas. Reg. § 1.338-5(c)(3).

e. As to T, prior to January 6, 2000, the price at which it is deemed to have sold its assets equals the MADSP. Treas. Reg. § 1.338(h)(10)-1(f)(1) (effective prior to January 6, 2000). The MADSP is then allocated among the assets being sold in accordance with the residual method. Id.

(1) Like AGUB, the MADSP is defined as the sum of

(a) P's grossed-up basis in recently purchased T stock (which presumably includes the acquisition costs);

(b) new T's liabilities; and

(c) other relevant items. Treas. Reg. § 1.338(h)(10)-1(f)(2) (effective prior to January 6, 2000).

(2) However, unlike in the definition of AGUB, in defining what constitutes "other relevant items" for purposes of MADSP, the regulations in effect prior to January 6, 2000 provide that "other relevant items” include reductions for--

(a) Acquisition costs of P incurred in connection with the qualified stock purchase that are capitalized in the basis of recently purchased T stock; and

(b) Selling costs of the selling consolidated group that reduce the amount realized on the sale of recently purchased T stock. Treas. Reg. § 1.338(h)(10)-1(f)(4) (effective prior to January 6, 2000); see also Treas. Reg. § 1.338(b)-1(g)(1) (effective prior to January 6, 2000).

(c) Thus, in the allocation of MADSP, the issue of allocating in excess of value is not presented.

f. With respect to T under both the temporary regulations and final regulations, it is deemed to have sold its assets for the ADSP. Treas. Reg. § 1.338(h)(10)-1(d)(3).

(1) The ADSP is defined as the sum of

(a) the grossed-up amount realized on the sale to P of P's recently purchased T stock (as defined in section 338(b)(6)(A)); and

(b) old T's liabilities. Treas. Reg. § 1.338-4(b)(1).

(2) In defining the grossed-up amount realized on the sale to P of P's recently purchased T stock, a reduction is allowed for the selling costs incurred by the selling shareholders in connection with the sale to P of P's recently purchased T stock that reduce their amount realized on the sale of the stock (e.g., brokerage commissions and any similar costs to sell the stock). Treas. Reg. § 1.338-4(c)(1)(iii).

g. NOTE: Although the section 338(h)(10) regulations effective prior to January 6, 2000 cited above do not adequately address the proper tax treatment of acquisition costs, they do eliminate a significant problem contained in the old temporary regulations concerning the MADSP formula.

(1) Under the old temporary regulations, the MADSP formula was not reduced by the purchaser's acquisition costs or the selling costs of the selling consolidated group. In effect, MADSP equaled AGUB. Temp. Treas. Reg. § 1.338(h)(10)-1T(f) (effective prior to January 19, 1994); Temp. Treas. Reg. § 1.338(h)(10)-1T(e)(6) (effective prior to January 19, 1994).

(2) The regulations under section 338(h)(10) effective prior to January 6, 2000 corrected this error.

(3) In defining the grossed-up amount realized, the new temporary regulations effective January 6, 2000 maintain the correction in the ADSP calculation.

E. Example 5 -- Interest Rate Considerations

1. Purchaser is acquiring an operating business that includes machinery and equipment (with a value of $1.7 million) and goodwill (with a value of $300,000). The purchase price is $2 million, of which $400,000 is in cash and the balance in a $1.6 million note bearing interest at the applicable Federal rate ("AFR"). The note has a fair market value of $1.3 million.

a. Because the note bears interest at AFR, no part of the stated principal on the note will be recharacterized as interest. Section 1274.

b. However, a note bearing interest at AFR will always have a lower market value than a note bearing a market rate of interest, because a private borrower cannot match the borrowing power and credit rating of the government.

c. In this **example (5)**, under section 1060, the seller's amount realized, as well as the purchaser's cost of its assets, equals $2 million (the sum of the cash and the stated principal amount of the note). Treas. Reg. § 1.1001-1(g) (the amount realized with respect to a debt instrument issued in exchange for property is its issue price); Treas. Reg. § 1.1012-1(g) (the cost of property that is acquired in exchange for a debt instrument is the issue price of the debt instrument).

(1) Purchaser obtains a greater amount to allocate to its assets, but a corresponding lower interest deduction on the note.

(2) Seller receives a higher amount realized on the assets but less interest income.

2. Alternatively, assume the note has a face amount of $1.3 million but pays an above-market interest rate such that its fair market value is $1.6 million.

a. Purchaser could avoid having to allocate any of the cost to the goodwill and would recoup the excess value via a larger interest deduction. This would prove beneficial for at least two reasons:

(1) If the term of the debt is less than 15 years, deductions may be claimed more rapidly than goodwill.

(2) Also, treatment as interest should avoid the loss deferral rules of section 197(f)(1)(A).

b. Seller has a lower amount realized on the sale but higher interest income.

c. However, if the interest is considered to be "clearly excessive," the issue price of the debt instrument is the fair market value of the property received in exchange for the debt instrument, reduced by the fair market value of any consideration other than the debt instrument issued in consideration for the sale or exchange. Treas. Reg. § 1.1274-2(b)(3).

(1) Interest on a debt instrument is considered to be clearly excessive "if the interest, in light of the terms of the debt instrument and the creditworthiness of the borrower, is clearly greater than the arm's length amount of interest that

would have been charged in a cash lending transaction between the same two parties." Treas. Reg. § 1.1274-3(b)(3).

(2) In this **example (5)**, assuming the interest is not excessive, the note would have an issue price of $1.6 million.

F. **Example 6 -- Bargain Purchase**

X Co. is engaged in a manufacturing business. Because of poor management, X Co. is under strong pressure from its shareholders to dispose of its business and liquidate. P is interested in acquiring X Co.'s business, but realizes the pressure that X Co. is under, and hence will only pay 60 cents on the dollar for X Co.'s assets. X Co. has the following assets, with values determined by an independent appraiser:

Asset	Basis	Fair Market Value
Cash	$ 100,000	$ 100,000
Land & Equip.	300,000	400,000
Account Receivable	150,000	150,000
Inventory	100,000	150,000
Goodwill	-0-	300,000
Total	$ 650,000	$1,100,000

1. The parties agree that P will purchase X Co.'s entire business for $650,000.

2. Under the regulations in effect prior to January 6, 2000, the $650,000 is allocated as follows:

a. $100,000 to Class I (cash).

b. $550,000 to Class III (land, equipment, accounts receivable, and inventory).

(1) The $550,000 allocated to Class III is allocated among the Class III assets in proportion to fair market value. Temp. Treas. Reg. § 1.1060-1T(d)(2) (effective prior to January 6, 2000).

(2) This results in the following allocations.

(a) $314,286 to land and equipment.

(b) $117,857 to accounts receivable.

(c) $117,857 to inventory.

3. Under both the new temporary and final section 1060 regulations, the $650,000 is allocated as follows:

a. $100,000 to Class I (cash).

b. $150,000 to Class III (accounts receivable).

c. $150,000 to Class IV (inventory).

d. $250,000 to Class V (land and equipment).

e. No consideration would be allocated to goodwill.

f. As a result of the allocation under the prior temporary regulations, gain would have been accelerated to the purchaser upon collection of accounts receivable and the sale of inventory, events which tend to occur rapidly. In contrast, with the full discount allocated to the land and equipment under the new temporary regulations, the effects on the purchaser are deferred, and taken into account through reduced depreciation and on the ultimate sale of the property.

4. QUERY: How are transaction costs treated in a bargain purchase?

a. If the cash consideration transferred to the seller is less than the fair market value of the assets acquired and transaction costs are considered an element of the purchaser's cost, then the basis arising from the transaction costs will be allocated among the acquired assets pursuant to the residual method under section 1060.

b. However, if pursuant to section 197(e)(8), transaction costs are treated as creating a separate section 197 intangible not acquired from the seller, the basis presumably would be allocated solely to that intangible.

G. **Example 7 - Treatment of Nonrecourse Indebtedness**

A owns the following assets:

	Basis	Fair Market Value
Plant & Equipment	$300,000	$400,000
Customer List	100,000	400,000
Total	$400,000	$800,000

The plant and equipment are subject to a nonrecourse debt of $700,000. P offers to purchase the entire business for $600,000 subject to the indebtedness.

1. A's amount realized is clearly $1.3 million. Section 7701(g); see also Commissioner v. Tufts, 461 U.S. 300 (1983); Temp. Treas. Reg. § 1.1060-1T(c)(2) (effective prior to January 6, 2000) ("For purposes of determining the amount of the seller's gain or loss, the fair market value of any property subject to nonrecourse indebtedness shall be treated as being not less than the amount of such indebtedness."); Treas. Reg. § 1.338-6(a)(2)(i).

    a. This amount realized is then allocated among the assets using the residual method.

    b. Under pre-section 197 law, treating the customer list as a Class III asset, $700,000 of the amount realized would be allocated to the plant and equipment (equal to the amount of the nonrecourse debt), $400,000 to the customer list, and $200,000 to goodwill.

    c. Under the old temporary regulations effective prior to January 6, 2000, the customer list is treated as a Class IV asset. Thus, $700,000 of the amount realized would be allocated to the plant and equipment (Class III), $400,000 is allocated to Class IV assets, and $200,000 is allocated to Class V assets. See Temp. Treas. Reg. § 1.338(b)-2T(b); Temp. Treas. Reg. §1.1060-IT(d)(2) (effective prior to January 6, 2000). Under both the temporary and final section 338 regulations, the customer list is treated as a Class VI asset, and $700,000 of the amount realized would be allocated to the plant and equipment (Class V), $400,000 is allocated to Class VI assets, and $200,000 is allocated to Class VII assets. Treas. Reg. §1.338-6(b).

2. What is P's cost in the acquired assets? Is it $600,000? Is it $1 million? Is it $1.3 million? How is the cost allocated under section 1060?

H. **Example 8 -- Transfers of Partnership Interests**

1. No Section 754 Election

a. Partnership AB was formed by individuals A and B. A contributed a depreciable business asset with a value of $300 and basis of $400, and self-generated goodwill (i.e., zero basis) valued at $150 to AB in exchange for a 75 percent interest in AB. B contributed $150 to AB in exchange for a 25 percent interest in AB.

b. A sells one-third of his interest in AB (a 25 percent interest) to C for $150. No section 754 election is made. C's basis in his partnership interest is $150.

c. Section 1060 does not apply to this transaction. Amortization of the goodwill is not allowed. See section 197(c)(2), (f)(2).

2. Section 754 Election Made

a. Same facts as in the example in section V.A.1., supra, except that AB has made an election under section 754.

b. Section 743 provides that the basis of partnership property is to be adjusted in the event of a transfer of a partnership interest where a section 754 election has been made.

(1) The partnership increases (or decreases) its "inside basis" in its assets to reflect the transferee's basis in the partnership interest.

(2) The basis adjustment is made only with respect to the transferee partner. Section 743(b).

(3) In this case, there will be an aggregate basis adjustment of $16.67 as a result of C's purchase of a 25 percent interest in AB (C's $150 cost basis in the partnership interest less C's $133.33 share of inside basis). See Treas. Reg. § 1.743-1 (rules determining the aggregate basis adjustment under section 743(b)).

c. Section 1060(d) provides that the allocation rules of section 1060(a) must be applied to determine the fair market value of any section 197 intangibles held by a partnership for purposes of applying section 755. Note, however, that the allocation of any basis adjustment under section 755 among the assets of a

partnership is governed by Treas. Reg. § 1.755-1 rather than by section 1060.

(1) Under Treas. Reg. § 1.755-1, for purposes of allocating a section 743(b) aggregate basis adjustment among partnership assets, the partnership's assets are divided into two classes -- (a) capital assets and section 1231 assets, and (b) all other assets (i.e., ordinary income assets). Treas. Reg. § 1.755-1(a)(1), (b).

(2) The aggregate section 743(b) basis adjustment is allocated between these two classes. Within each class, the allocated basis adjustment is then further allocated among the assets of the class. Treas. Reg. § 1.755-1(a)(1), (b).

(3) Regulations under section 755 provide for allocations of basis adjustments under section 743 (between the two classes and then among the assets within each class) based on the amount of income, gain, or loss that the transferee partner would be allocated if, immediately after the section 743(b) transfer, all of the partnership's assets were disposed of in a taxable transaction at "fair market value." See Treas. Reg. § 1.755-1(b)(1)(ii).

(4) For purposes of applying these allocation rules and to carry out the intent of section 1060(d), finalized regulations under section 755 provide rules for determining the "fair market value" of a partnership's "section 197 intangibles," which is defined for purposes of section 755 to include all section 197 intangibles plus goodwill and going concern value that does not qualify under section 197(d) as a section 197 intangible. Treas. Reg. § 1.755-1; T.D. 9059 (June 6, 2003). These regulations replace Temp. Treas. Reg. § 1.755-2T and modify portions of Treas. Reg. § 1.755-1 as it existed prior to June 6, 2003.

(5) The final regulations are generally effective for transfers of partnership interests and distributions of property from a partnership that occur on or after December 15, 1999; however, subsections 1.755-1(a) and 1.755-1(b)(3)(iii) of the new final regulations are effective for transfers of partnership interests and distributions of property from a partnership that occur on or after June 6, 2003.

(6) Under the final regulations, partnerships must determine the "fair market value" of section 197 intangibles (including goodwill and going concern value that do not

qualify as section 197 intangibles) for purposes of allocating basis adjustments under section 743(b) as follows:

(a) First, the partnership must determine the aggregate fair market value of all partnership assets, excluding section 197 intangibles. Treas. Reg. § 1.755-1(a)(3).

(b) Second, the partnership must determine the amount that, if assigned to all partnership property, would allow the transferee-partner to receive in a liquidating distribution an amount equal to the transferee's basis in his partnership interest, minus the basis attributable to partnership liabilities (the "partnership gross value"). Treas. Reg. § 1.755-1(a)(4)(i)(A).

(c) Third, compare the aggregate value of the partnership assets (excluding section 197 intangibles) with the partnership gross value.

  i) If the aggregate value of the partnership assets (excluding section 197 intangibles) equals or exceeds the partnership gross value, the section 197 intangibles are deemed to have a "fair market value" of zero.

  ii) If the partnership gross value exceeds the aggregate value of the partnership assets (excluding section 197 intangibles), such excess is the "fair market value" of the section 197 intangibles. Treas. Reg. § 1.755-1(a)(5).

(d) To the extent that the section 197 intangibles have a positive "fair market value," this value generally is allocated among the partnership's various section 197 intangibles as follows:

  i) first, to section 197 intangibles (other than goodwill and going concern value) up to their respective fair market values;

  ii) second, to goodwill and going concern value. Id.; see generally Treas. Reg. § 1.755-1(a)(2).

d. Under the new final regulations, the value of partnership AB's section 197 intangibles (i.e., the goodwill) is determined as follows:

(1) The aggregate value of the partnership assets (excluding section 197 intangibles) is $450 ($300 depreciable asset plus the $150 cash);

(2) The partnership gross value is $600 (the amount that the partnership must be worth in order for C to receive a liquidating distribution equal to his $150 outside basis);

(3) The "fair market value" of the partnership's section 197 intangibles (i.e., the goodwill) is $150 ($600 partnership gross value minus the $450 aggregate value of the partnership's assets, excluding section 197 intangibles);

(4) This $150 of section 197 intangible "fair market value" is allocated entirely to the goodwill.

e. The $16.67 aggregate basis adjustment in the partnership's assets (with respect to C) is allocated in accordance with C's distributive share of income, gain, or loss from the hypothetical sale transaction in Treas. Reg. § 1.755-1(b)(1)(ii). Since C would be allocated $50.00 of gain from the hypothetical sale of the goodwill pursuant to section 704(c) and $33.33 of loss from the sale of the depreciable business asset pursuant to section 704(c), a $50.00 upward basis adjustment is made to AB's goodwill (only with respect to C) and a $33.33 downward basis adjustment is made to AB's depreciable business asset (only with respect to C). See also Treas. Reg. § 1.755-1(b)(2)(ii) exs. 1, 2, -1(b)(3)(iv) exs. 1, 2.

(1) The partnership's basis in its assets (with respect to C) is thus:

Cash	$37.50
Depreciable Asset	66.66
Goodwill	50.00

(2) Under these facts, the section 743(b) basis adjustment to the goodwill is treated as a separate asset acquired by AB on the date C purchased its interest in AB, and, therefore, that separate asset is treated as an amortizable section 197 intangible the basis of which (i.e., $50) is amortized over 15 years (but only with respect to C). See Treas. Reg. § 1.197-2(g)(3), -2(k) ex. 19.

f. Had C purchased directly a 25 percent interest in the assets of AB for $150, consideration (and thus basis) would have been allocated under section 1060 and would have been:

Cash	$37.50
Depreciable Asset	75.00
Goodwill	37.50

See Treas. Reg. §§ 1.338-6, 1.1060-1(c).

3. Distribution of partnership property under section 734(b)

a. While section 1060(d) on its face applies to basis adjustments under section 734(b), the old temporary regulations explaining section 1060 made no mention of basis adjustments under section 734(b). Until the recent issuance of the new final section 755 regulations, which do provide rules for basis adjustments under section 734(b), such omission may have been viewed as indicating that the Service did not interpret section 1060(d) as applying in the case of basis adjustments under section 734(b). Note, however, that section 1060(d), which was added to the Code as part of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, was enacted on November 10, 1988, some four months after the issuance of Treas. Reg. § 1.755-2T.

b. In general, the new final section 755 regulations use the same method of determining and allocating the "fair market value" of section 197 intangibles for purposes of section 734(b) as they do for purposes section 743(b). See Treas. Reg. § 1.755-1(a)(2).

c. However, there is one difference, which concerns the definition of partnership gross value.

(1) For purposes of section 734(b), partnership gross value equals the value of the entire partnership as a going concern immediately following the distribution causing the adjustment, increased by the amount of partnership liabilities immediately following the distribution. Treas. Reg. § 1.755-1(a)(4)(iii).

(2) For purposes of section 743(b), partnership gross value equals the amount that, if assigned to all partnership property, would allow the transferee-partner to receive in a liquidating distribution an amount equal to the transferee's basis in his partnership interest, minus the basis attributable

to partnership liabilities. Treas. Reg. § 1.755-1(a)(4)(i)(A).

d. Note further that the aggregate basis adjustment under section 734(b) is allocated among the undistributed assets of the partnership in a manner different than the way an aggregate basis adjustment under section 743(b) is allocated among partnership assets. In general, section 734(b) adjustments are allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose (e.g., capital gain property or ordinary income property). See Treas. Reg. § 1.755-1(c)(1). An allocation of basis from a section 734(b) adjustment to a particular class of property (e.g., capital gain property) then is allocated generally among the assets within such class in proportion to their unrealized appreciation or depreciation, depending on the direction of the allocated section 734(b) adjustment. Treas. Reg. § 1.755-1(c)(2).

I. Example 9 -- The Section 197 Anti-Churning Rules

1. Basic fact pattern

Target operates a major newspaper operation. Target's assets (as of December 31, 1993) include the following:

Asset	Basis	Fair Market Value
Equipment	$ -0-	$ 5,000,000
Customer list	1,000,000	10,000,000
Goodwill	1,000,000	10,000,000
Total	$2,000,000	$25,000,000

The customer list is not an amortizable section 197 intangible while owned by Target. Target's goodwill is self-created and, therefore, is ineligible for section 197 treatment in the hands of Target. Both intangible assets have been held by Target since 1991. Target's tangible assets have been fully depreciated (hence the zero basis). Target and P (an unrelated taxpayer) are negotiating the terms of an agreement by which P would acquire in 1994 a 60-percent interest in Target's newspaper operation for $15 million cash. Target and P are analyzing the following forms for the acquisition:

a. A direct purchase of a 60 percent interest in the assets by P for $15 million, followed by a contribution by P of the acquired 60 percent interest in the assets to a newly-organized limited liability

company ("LLC")[6] in exchange for a 60 percent interest in the LLC (whose interest will be contributed to a special purpose subsidiary), and a contribution by Target of the remaining 40 percent interest in the assets to the LLC (excluding the cash proceeds) in exchange for a 40 percent interest in the LLC (the "asset acquisition method");

b. A contribution by Target of the newspaper assets to an LLC, followed by a sale of a 60 percent interest in the LLC to P for $15 million, with P contributing the LLC interest to a special purpose subsidiary (the "deemed asset acquisition method"); or

c. A contribution by Target of the newspaper assets to an LLC in exchange for a 99 percent interest in the LLC, and a contribution by an accommodation party of cash to the LLC in exchange for a 1 percent interest in the LLC that will make a timely election under section 754, followed by Target's sale of a 60 percent interest in the LLC to P for $15 million, with P contributing the LLC interest to a special purpose subsidiary (the "partnership acquisition method"); or

d. A contribution by Target of 60 percent of its newspaper assets to a newly-organized wholly owned subsidiary ("Newco"), followed by a sale of the Newco stock to P for $15 million, where a section 338(h)(10) election is made, with Newco contributing the assets to an LLC in exchange for a 60 percent interest in the LLC and Target contributing the balance of the assets (excluding the cash proceeds) to the LLC in exchange for a 40 percent interest in the LLC (the "stock acquisition method").

2. <u>Same operating structure</u>

In each of the methods, the operating structure is the same:

a. As to P, the acquired assets are owned by an LLC, 60 percent of which is owned by a wholly-owned subsidiary of P,[7] where P has a FMV basis in (i) its proportionate share of the LLC assets, (ii) the LLC interest, and (iii) the stock of the special purpose subsidiary.

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[6] Assume that the LLC will be treated as a partnership for Federal income tax purposes.

[7] Assume that P and the special purpose subsidiary file a consolidated Federal income tax return.

b. As to Target, its interest in the newspaper assets is owned by an LLC, 40 percent of which is owned by Target,[8] where Target has a carryover basis in the LLC interest.

c. The only difference in operating structure concerns the partnership acquisition method, under which Target owns a 39 percent interest in the LLC and the underlying assets of the LLC.

3. Application of section 197

The application of section 197, however, differs dramatically depending on the form of the acquisition:

a. Asset acquisition method

(1) No Retroactive Election Made

(a) If the acquisition takes the form of the asset acquisition method, it appears that the anti-churning rules would apply to disallow any amortization deduction by the LLC under section 197 with respect to the goodwill if no retroactive election is made in time. See Treas. Reg. § 1.197-2(k), ex.18.

(b) The anti-churning rules apply to any goodwill "which is acquired by the taxpayer after [August 10, 1993], if the intangible was held or used at any time on or after July 25, 1991, and on or before [August 10, 1993] by the taxpayer or a related person. . . ." Section 197(f)(9)(A)(i).

(c) For purposes of the anti-churning rules, a person is related to another person if the related person bears a relationship to such person as provided in section 267(b) or 707(b), except that the 50-percent threshold is reduced to 20 percent. Section 197(f)(9)(C)(i)(I) (and flush language). See Treas. Reg. § 1.197-2(h)(6).

(d) In this example (9), after taking into account the reduced threshold levels, the LLC is "related" to Target pursuant to section 707(b)(1)(A). Since the goodwill was held by Target before August 10, 1993, it appears that the goodwill contributed by P would not be treated as an amortizable section 197

[8] In order to simplify the example, Target is the direct owner of the LLC interest.

intangible. See Treas. Reg. §§ 1.197-2(h)(6), -2(k), ex. 16.

i) There is no policy reason for this result, provided that Target does not receive any benefit of the amortization deduction.

ii) However, if A elects to recognize gain under Treas. Reg. § 1.197-2(h)(9) on the transfer of the intangible to P and the LLC, then the intangible would be amortizeable by the LLC.

(e) Assuming the anti-churning rules apply, the LLC's basis in the contributed goodwill equals $6.4 million ($400,000 carryover basis in the goodwill contributed by Target plus $6 million carryover basis in the goodwill contributed by P). Similarly, the LLC would have a $6.4 million basis in the customer list, and a $3 million basis in the tangible assets.

i) P's basis in the acquired goodwill would not be recoverable under section 197 in the hands of P. See, e.g., Treas. Reg. § 1.197-2(k) ex. 18.

ii) Since the anti-churning rules generally apply only to goodwill and going concern value,[9] the rules would not apply to the customer list in the hands of the LLC. See Treas. Reg. § 1.197-2(h)(1)(i). (Therefore, the LLC would be entitled to an annual amortization deduction under section 197 equal to $400,000 ($6 million/15 years) with respect to the portion of the customer list attributable to P.

iii) The $400,000 portion of the carryover basis in the customer list attributable to Target would not qualify as an amortizable section 197 intangible. Section 197(f)(2).

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[9] In addition to goodwill and going concern value, the anti-churning rules apply to any other section 197 intangible "for which depreciation or amortization would not have been allowable but for [section 197]…." Section § 197(f)(9)(A).

(2) Retroactive Election Made

(a) If P has made a retroactive election to apply section 197 to all intangible assets acquired after July 25, 1991 and on or before August 10, 1993, the anti-churning rules will not apply, and P will be allowed amortization deductions from the LLC with respect to the goodwill and customer list held by the LLC. Treas. Reg. § 1.197-1T.

i) The Small Business Act clarified that, if a taxpayer and its related parties make the retroactive election, the anti-churning rules will not apply when property acquired from an unrelated party after July 25, 1991 is transferred to a taxpayer related to the acquirer after August 10, 1993. H. Rep. No. 104-586. The effect of this new provision is questionable, as it was enacted in 1996, well after the last date P is allowed to make the retroactive election (i.e., P must make the election by the due date, including extensions, of P's tax return that includes August 8, 1993).[10] Temp. Treas. Reg. § 1.197-1T(c)(3). If P has not made a retroactive election in time, the rules in (1), above, apply.

ii) The temporary regulations provide that if property is transferred in a transaction described in section 721 or 731, and the retroactive election is made by the transferor, the property remains subject to section 197 in the hands of the transferee to the extent of the basis in the hands of the transferor.[11] Temp. Treas. Reg. § 1.197-1T(c)(iv). Thus, section 197 will apply to the intangibles transferred to LLC to the extent of P's basis, but appreciation from the time P received the goodwill from T to the

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[10] If P's tax return is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994. Temp. Treas. Reg. § 1.197-1T(c)(3)(i).

[11] The transferee does not have to make the retroactive election and thus does not have to apply section 197 to any other property it owns from July 25, 1991 to August 10, 1993.

time P transferred it to LLC will not be subject to section 197 unless LLC, too, has made a retroactive election.[12]

iii) This rule applies as long as P acquired the goodwill from T after July 25, 1991, and transferred the goodwill to LLC after August 10, 1993.

b. Deemed asset acquisition method

(1) Unless Target checks the box to treat the LLC as an association for Federal tax purposes, the LLC, and Target's contribution thereto, are disregarded for tax purposes. See Treas. Reg. § 301.7701-2(a). The assets of the newspaper operation are treated as owned directly by Target. See id.

(2) Under Rev. Rul. 99-5, 1999-1 C.B. 434, Target is treated as selling directly to P a 60 percent interest in the assets of the newspaper operation, followed by a contribution by Target and P (or P's wholly owned subsidiary) of the assets of the newspaper operation to a newly formed partnership (the LLC) in section 721 transactions.

(3) Thus, the results should be exactly the same as the asset acquisition method.

c. Partnership acquisition method

(1) As previously discussed, in a partnership acquisition with a section 754 election in effect, section 197 applies only to the extent of any increase in the basis of partnership property under section 732, 734, or 743.

(2) P's proportionate share of the aggregate adjusted basis of the assets is $1.2 million. See Treas. Reg. §1.743-1. P's aggregate basis adjustment under section 743(b)(1) equals $13.8 million.

(a) As described in **example (8)**, the assets are divided into two classes: (i) capital assets and section 1231 assets, and (ii) all other assets, and

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[12] Obviously, if LLC does not exist until after the final date to make the retroactive election, it cannot make such election.

(b) the aggregate basis adjustment is allocated between the two classes (and then among the assets within each class) based upon the amount of income, gain, or loss attributable to the two classes of assets (and then with respect to each assets within each class) that would be allocated to P if, immediately after the section 743(b) transfer, all of the partnership's assets were disposed of in a taxable transaction at fair market value. Treas. Reg. § 1.755-1(b).

(3) Under section 755, the $13.8 million aggregate basis adjustment in the LLC's assets (with respect to P) is allocated as follows:

Equipment	$3.0 million
Customer list	5.4 million
Goodwill	5.4 million

(4) With respect to each of the LLC's section 197 intangibles, the LLC is treated as owning two assets for purposes of allocating amortization deductions to P. See Treas. Reg. §1.197-2(g)(3), -2(k) exs. 16, 18.

(a) For one asset, P's share of the LLC's adjusted basis is the same as Target's share (i.e., $0). Thus, no amortization is allowed for the asset.

(b) For the other asset, P's proportionate share of the newly adjusted basis of the section 197 intangible (due to the section 743 adjustment) is amortized over a 15-year period.

(5) Thus, P would be entitled to an annual amortization deduction of $720,000 ($10.8 million/15 years) attributable to the goodwill and customer list.

(6) The anti-churning rules do not apply in the partnership acquisition method. <u>See</u> Treas. Reg. § 1.197-2(k), Ex.19.

(a) With respect to an increase in the basis of partnership property under section 732, 734, or 743, the anti-churning rules are applied at the partner level, and each partner is treated as having owned and used such partner's proportionate share of the partnership assets. Section 197(f)(9)(E).

(b) Under the final section 197 regulations, P is not related to Target, and the anti-churning rules do not apply.[13] Treas. Reg. § 1.197-2(h)(12)(v).

(c) NOTE: In the proposed regulations, the anti-churning rules did not apply in the partnership acquisition method only if the formation of the partnership and the sale of the interests were "unrelated." Prop. Treas. Reg. § 1.197-2(k) ex.17. The final regulations remove the requirement that the transactions be unrelated. See Treas. Reg. § 1.197-2(k) ex.19. The Preamble states, however, that if the transaction is not properly characterized as a sale of a partnership interest, then section 197 will apply to the transaction as recast to reflect its true economic substance. Preamble, 65 Fed. Reg. at 3,822; see, e.g., Rev. Rul. 70-140, 1970-1 C.B. 73.

(d) The disparate tax treatment as between the asset acquisition method and the partnership acquisition method makes little sense and is fundamentally inconsistent with the purpose of section 754. The anti-churning rules should be amended so that in an asset acquisition followed by a contribution to a partnership, the acquiring partner is in the same tax position for purposes of section 197 as it would have been had it obtained an increased basis in the partnership assets pursuant to section 754. Although commentators suggested such a change, the suggestion was not adopted in final regulations. See Preamble, 65 Fed. Reg. at 3,822.

d. Stock acquisition method

(1) Section 197 applies to any section 197 intangible that is treated as acquired under section 338. See Treas. Reg. § 1.197-2(e)(5), 2(f)(4)(ii), -2(h)(8).

(2) In this **example (9)**, the acquisition of the Newco stock is treated as an acquisition of the Newco assets. P takes a basis in the Newco stock equal to $15 million. Section 1012.

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[13] The other situations in which the anti-churning rules could apply, namely, where the user of the intangible remains unchanged (section 197(f)(9)(A)(ii)) or the prior owner continues to use the intangible (section 197(f)(9)(A)(iii)) do not exist in this example.

(a) Newco's aggregate inside basis of its assets is equal to its AGUB, which in this example equals $15 million. Treas. Reg. § 1.338-5; Treas. Reg. §1.338(h)(10)-1(d).

(b) Under the residual method prescribed by Temp. Treas. Reg. § 1.338-6T(b), the AGUB is allocated as follows:

Equipment	$3.0 million
Customer list	6.0 million
Goodwill	6.0 million

(3) The contribution by Newco of the assets to the LLC is a transfer to which section 721 applies. The LLC steps into the shoes of Newco for purposes of applying section 197. Section 197(f)(2).

(a) For the reasons explained above under the asset acquisition method, the anti-churning rules seem to prevent the LLC from claiming an amortization deduction with respect to the acquired goodwill if no retroactive election is made.

(b) This rather undesirable result could be avoided by either making the retroactive election, or merely reversing the sequence of events -- i.e., have Target contribute the assets to the LLC (with a timely election under section 754 in effect), and have Target contribute 60 percent of the LLC interest to Newco, prior to P's purchase of the Newco stock.[14] Subsequently, when the parties make the joint election under section 338(h)(10), the basis in the goodwill is increased by reason of section 743, and for the reasons described in connection with the partnership acquisition method, the anti-churning rules would not apply.

[14] In order for this to work, however, the LLC must have at least one additional member. Without two members, the LLC cannot be treated as a partnership for Federal tax purposes. See Treas. Reg. § 301.7701-2(a). Under these circumstances, the LLC should not be treated as a partnership and it should not be permitted to make a valid section 754 election.

J. **Example 10 -- Overlap With Economic Performance Rules**

M, a manufacturing company, acquires the assets of R, a rival company. Among the assets acquired from R is a favorable supplier contract that entitles M to receive a specified amount of raw materials for the next 25 years (the remaining life of the contract). The value attributable to the favorable contractual right is $375,000.

1. The favorable contractual right is a section 197 intangible. Section 197(d)(1)(v)-(d)(3). As a result, M should be allowed an annual amortization deduction of $25,000 ($375,000/15 years).

2. However, under the economic performance rules, when the taxpayer's liability arises out of the providing of property to the taxpayer, economic performance occurs as the person provides such property. Section 461(h)(2)(A)(ii). If the economic performance rules in fact override section 197, the $375,000 would have to be amortized over a 25-year period, resulting in an annual amortization deduction of $15,000.

3. According to at least one Treasury official, nothing in section 197 or the legislative history suggests that section 197 was intended to override the economic performance rules. Therefore, in this **example (10)**, the proper amortization period is 25 years. See "Government Officials Discuss Intangibles Amortization Issues," Tax Analyst's Daily Tax Highlights & Documents, Vol. 34, No. 1 at p. 5 (July 1, 1994).

APPENDIX A
(Form 8594)

Form **8594**
(Rev. February 2006)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060

► Attach to your income tax return. ► See separate instructions.

OMB No. 1545-1021
Attachment Sequence No. 61

Name as shown on return | Identifying number as shown on return

Check the box that identifies you:
☐ Purchaser ☐ Seller

Part I General Information

1 Name of other party to the transaction | Other party's identifying number

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

2 Date of sale | 3 Total sales price (consideration)

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☐ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . ☐ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . . ☐ Yes ☐ No

If "Yes," attach a schedule that specifies (a) the type of agreement and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

Part III **Supplemental Statement—**Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration. See instructions.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

APPENDIX B
(Form 8883)

Form **8883**
(December 2008)
Department of the Treasury
Internal Revenue Service

Asset Allocation Statement
Under Section 338

► Attach to your income tax return. ► See separate instructions.

OMB No. 1545-1806

Part I Filer's Identifying Information

1a Name as shown on return

1b Identifying number as shown on return

1c Check applicable box (see instructions):
☐ Old target ☐ New target

1d Was a valid and timely Form 8023 filed? . . . ☐ Yes ☐ No
If yes, enter the date filed ►

Part II Other Party's Identifying Information

2a Name of other party to the transaction

2b Other party's identifying number

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

Part III Target Corporation's Identifying Information

3a Name and address of target corporation

3b Employer identification number

3c State or country of incorporation

Part IV General Information

4a Acquisition date

4b What percentage of target corporation stock was purchased:
(i) During the 12-month acquisition period? ________ %
(ii) On the acquisition date? . . . . %

5a Stock price	**5b** Acquisition costs/Selling costs	**5c** Target liabilities	**5d** AGUB/ADSP
$	$	$	$

		Yes	No
6	Was the filer listed in Part I, above, a member of an affiliated group of corporations before the acquisition date?		
7	Was the target corporation a member of an affiliated group before the acquisition date?		
8	Is the target corporation or any target affiliate:		
a	A controlled foreign corporation? If "No," check here if it was a CFC at any time during the preceding 5 years ► ☐		
b	A foreign corporation with income, gain, or loss effectively connected with the conduct of a trade or business within the United States (including U.S. real property interests)?		
c	A qualifying foreign target under Regulations section 1.338-2(e)(1)(iii)?		
d	A corporation electing under section 1504(d) or section 953(d)?		
e	A domestic international sales corporation (DISC)?		
f	A passive foreign investment company (PFIC)?		
g	If the answer to item 8f is "Yes," is the PFIC a pedigreed qualified electing fund?		

Part V Original Statement of Assets Transferred

9 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of AGUB or ADSP
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

Part VI Supplemental Statement of Assets Transferred—Complete if amending an original statement or previously filed supplemental statement because of an increase or decrease in AGUB or ADSP.

10 Enter the tax year and tax return form number with which the original Form 8023 or Form 8883 and any supplemental statements were filed.

11 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of AGUB or ADSP
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

12 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

APPENDIX C
(Form 8023)

Form **8023**
(Rev. February 2006)
Department of the Treasury
Internal Revenue Service

Elections Under Section 338 for Corporations Making Qualified Stock Purchases

▶ See separate instructions.

OMB No. 1545-1428

Section A-1—Purchasing Corporation

1a Name and address of purchasing corporation	1b Employer identification number	
	1c Tax year ending	1d State or country of incorporation

Section A-2—Common Parent of the Purchasing Corporation

2a Name and address of common parent of purchasing corporation	2b Employer identification number	
	2c Tax year ending	2d State or country of incorporation

Section B—Target Corporation

3a Name and address of target corporation	3b Employer identification number	
	3c Tax year ending	3d State or country of incorporation

Section C—Common Parent of Selling Consolidated Group, Selling Affiliate, S Corporation Shareholder, or U.S. Shareholder

Complete only for a section 338(h)(10) election or if target was a member of a consolidated group or a controlled foreign corporation (CFC) or had been a CFC within the preceding five years.

4a Name and address of common parent of the selling consolidated group, selling affiliate, U.S. shareholder(s) of foreign target corporation, or S corporation shareholder(s)	4b Identifying number(s)
	4c Tax year ending

Section D—General Information

5a Acquisition date	5b What percentage of target corporation stock was purchased: *(i)* During the 12-month acquisition period? ________ % *(ii)* On the acquisition date? %

Section E—Elections Under Section 338

6	Check here to make a section 338(h)(10) election for the target corporation listed in Section B on page 1 . . . . ▶	☐
7	Check here to make a section 338 election (other than a section 338(h)(10) election) for the target corporation listed in Section B on page 1. . . . . . . ▶	☐
8	If the box on line 7 is checked for the target corporation listed in Section B on page 1, check here to make a gain recognition election for that corporation (see instructions) . . . . . . ▶	☐
9	Check here if this form is filed to make a section 338 election for any target corporation in addition to the one listed in Section B on page 1. . . . . . . ▶	☐

Purchasing Corporation(s) Signature(s)

Under penalties of perjury, I state and declare that I am authorized to make the election(s) on lines 6, 7, 8, and 9 on behalf of the purchasing corporation(s).

▶ Signature of authorized person for purchasing corporation(s) Date ▶ Title

Consolidated Selling Group or Selling Affiliate Signature (Section 338(h)(10) Election)

Under penalties of perjury, I state and declare that I am authorized to make the section 338(h)(10) election on line 6 on behalf of the common parent of the selling consolidated group or on behalf of the selling affiliate.

▶ Signature of authorized person for the common parent or selling affiliate Date ▶ Title

S Corporation Shareholder(s) Signature(s) (Section 338(h)(10) Election)

Under penalties of perjury, I state and declare that I am a shareholder of the S corporation target or that I am authorized to make the section 338(h)(10) election on line 6 on behalf of that shareholder. If more than one shareholder, attach a schedule with other signatures.

▶ Signature of S corporation shareholder Date ▶ Title

Printed on recycled paper

APPENDIX D
Form 8806

Form **8806**
(Rev. February 2006)
Department of the Treasury
Internal Revenue Service

Information Return for Acquisition of Control or Substantial Change in Capital Structure

OMB No. 1545-1869

Part I **Reporting Corporation** (see instructions)

1a Name of reporting corporation

b Address of reporting corporation

c EIN of reporting corporation

2a Name of reporting corporation's common parent, if any

b Address of reporting corporation's common parent

c EIN of reporting corporation's common parent

Part II **Acquiring Corporation** (see instructions)

3a Name of acquiring corporation

b Address of acquiring corporation

c EIN of acquiring corporation

d Was the acquiring corporation newly formed prior to its involvement in the transaction? . . . . ☐ Yes ☐ No

4a Name of acquiring corporation's common parent, if any

b Address of acquiring corporation's common parent

c EIN of acquiring corporation's common parent

Part III **Information About Acquisition of Control or Substantial Change in Capital Structure**

5a Date of transaction(s) that resulted in the acquisition of control or substantial change in capital structure

b Description of the transaction(s) ►

6a Did the reporting corporation's shareholders receive any stock or other property in exchange for their stock in the reporting corporation, for which the reporting corporation has reasonably determined that the shareholders are required to recognize gain (if any) from the exchange of such stock? (If "Yes," go to lines 6b and 6c) . . . . . . ☐ Yes ☐ No

b Fair market value of the stock or other property received 6b

c Description of the stock or other property received ►

Sign Here

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

► Signature of officer ► Date

Paid Preparer's Use Only

Preparer's signature ►	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ►		EIN	
		Phone no. ( )	

Part IV **Consent Election**

7 Does the reporting corporation consent to the publication of its name and address, date of transaction(s), description of shares affected by the transaction(s) and the amount of cash and fair market value of any property provided to each class of shareholders in exchange for a share, on an IRS website and/or in an IRS publication, as described in Regulations section 1.6043-4(a)(2), to assist brokers to satisfy their reporting obligations under Regulations section 1.6043-4(b)? . . . . ☐ Yes ☐ No

Under penalties of perjury, I declare that I am an officer of the above named corporation and that I am authorized to give consent on behalf of the above named corporation for the IRS to publish the information necessary to enable brokers to satisfy their reporting obligations under Regulations section 1.6043-4(b).

Sign Here ► Signature of officer Date Title

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

A reporting corporation must file Form 8806 to report an acquisition of control or a substantial change in the capital structure of a domestic corporation that occurred after December 4, 2005. The reporting corporation or any shareholder is required to recognize gain (if any) under section 367(a) and its regulation as a result of the transaction.

Definitions

Acquisition of Control of a Corporation

Generally, an acquisition of control of a corporation (first corporation) occurs if, in a transaction or series of related transactions:

- Before an acquisition of stock of the first corporation (directly or indirectly) by the second corporation, the second corporation does not have control of the first corporation;
- After the acquisition, the second corporation has control of the first corporation;
- The fair market value of the stock acquired in the transaction and in any related transactions as of the date or dates on which such stock was acquired is $100 million or more;
- The shareholders of the first corporation receive stock or other property pursuant to the acquisition; and
- The first corporation or any shareholder of the first corporation is required to recognize gain (if any) under section 367(a) and the regulations, as a result of the transaction.

Control. Control means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock.

Substantial Change in Capital Structure of a Corporation

A corporation has a substantial change in capital structure if it has a change in capital structure and the amount of any cash and the fair market value of any other property (including the value of any stock) provided to the shareholders of such corporation pursuant to the change in capital structure, as of the date or dates on which the cash or other property is provided, is $100 million or more. Generally, a corporation has a change in capital structure if:

1. The corporation in a transaction or series of transactions:

- Merges, consolidates, or otherwise combines with another corporation or transfers all or substantially all of its assets to one or more corporations;
- Transfers all or part of its assets to another corporation in a Title 11 or similar case and, in pursuance of the plan, distributes stock or securities of that corporation; or
- Changes its identity, form, or place of organization; and

2. The corporation or any shareholder is required to recognize gain (if any) under section 367(a) and the regulations, as a result of the transaction.

Receipt of property. A shareholder is treated as receiving property (or as having property provided to it) related to an acquisition of control or a substantial change in capital structure if a liability of the shareholder is assumed in the transaction and, as a result of the transaction, an amount is realized by the shareholder from the sale or exchange of stock.

Reporting Corporation

A reporting corporation is a corporation whose stock was acquired in an acquisition of control or that had a substantial change in its capital structure.

Acquiring Corporation

The acquiring corporation is any corporation that acquired control of the reporting corporation or received assets from the reporting corporation pursuant to a substantial change in capital structure of the reporting corporation.

Who Must File

A reporting corporation is required to file Form 8806 if the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a) to the transaction.

If the reporting corporation transfers all or substantially all of its assets to an acquiring corporation in a transaction that constitutes a substantial change in the capital structure of the reporting corporation and the reporting corporation does not file Form 8806, then the acquiring corporation must file Form 8806. If neither corporation files Form 8806, both corporations are jointly and severally liable for any applicable penalties. *See Penalties for Failure To File* below.

Corporations Not Required To File

Do not file Form 8806:

- For transactions that were properly reported under section 6043(a); or
- If the reporting corporation reasonably determines that all of its shareholders who receive cash, stock, or other property related to the acquisition of control or substantial change in capital structure are exempt recipients under Regulations section 1.6043-4(b)(5).

When To File

File Form 8806, within 45 days after the transaction, or if earlier by January 5th of the calendar year following the year in which the acquisition of control or substantial change in capital structure occurred.

Where To File

Mail Form 8806 to:

Internal Revenue Service
Large and Midsize Business Division
Attention: PFTS
1111 Constitution Ave., NW
Washington, DC 20224

Penalties for Failure To File

Caution: *Form 8806 and all Forms 1099-CAP, Changes in Corporate Control and Capital Structure, required to be filed under Regulations sections 1.6043-4(a) and (b) will be considered as one return for purposes of the failure to file penalty under section 6652(l).*

If a correct Form 8806 is not filed by the due date of the corporation's income tax return, including extensions, it may be penalized $500 for each day the return is late, up to a maximum of $100,000. The penalty will not be imposed if the corporation can show that the failure to file on time was due to reasonable cause. Corporations that file late must attach a statement explaining the reasonable cause. Additional penalties may apply under sections 7203, 7206, and 7207.

Note. Failure to file also includes the requirement to file on magnetic media as required by section 6011(e) and Regulations section 1.6011-2.

Information Returns Regarding Shareholders

A corporation required to file Form 8806 also must file Form 1099-CAP for certain shareholders of record who receive cash or other property (including stock) in exchange for their stock in the reporting corporation due to the acquisition of control or the substantial change in capital structure. See Form 1099-CAP for more information.

Specific Instructions

Employer identification number (EIN). An EIN must be included for each corporation identified. An EIN is not required if the corporation does not have, and is not otherwise required to have, an EIN.

Common parent of the reporting corporation. If the reporting corporation was a subsidiary member of a consolidated group immediately prior to the reportable transaction, complete lines 2a and 2b.

Common parent of the acquiring corporation. If the acquiring corporation was a subsidiary member of a consolidated group at the time of the change in control or substantial change in capital structure, complete lines 4a and 4b.

Part IV–Consent Election

A reporting corporation may elect to consent to the IRS publication (on the IRS website and/or an IRS publication) of information included on this form, to be limited to the name and address of the corporation, the date of the transaction, a description of the shares affected by the transaction, and the amount of cash and the fair market value of any property provided to shareholders in exchange for a share. See Regulations section 1.6043-4(a)(2).

Corporations that elect to consent to such publication are not required to file Form 1099-CAP with respect to shareholders that are clearing organizations, or to furnish Form 1099-CAP to such organizations. See Regulations section 1.6043-4(b)(1) and (4).

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this tax form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping . . . . 6 hr., 42 min.
Learning about the law or the form . . . . 2 hr., 10 min.
Preparing and sending the form to the IRS . . 2 hr., 23 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224. **Do not** send this form to this address. Instead see *Where To File* on page 2.

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APPENDIX E
(Forms 1096 and 1099-CAP)

Do Not Staple 6969

Form **1096**

Department of the Treasury
Internal Revenue Service

Annual Summary and Transmittal of U.S. Information Returns

OMB No. 1545-0108

2011

FILER'S name

Street address (including room or suite number)

City, state, and ZIP code

Name of person to contact	Telephone number ( )	For Official Use Only
Email address	Fax number ( )	

1 Employer identification number	2 Social security number	3 Total number of forms	4 Federal income tax withheld $	5 Total amount reported with this Form 1096 $

6 Enter an "X" in only one box below to indicate the type of form being filed.

7 If this is your **final return**, enter an "X" here . . . . ▶ ☐

W-2G 32	1097-BTC 50	1098 81	1098-C 78	1098-E 84	1098-T 83	1099-A 80	1099-B 79	1099-C 85	1099-CAP 73	1099-DIV 91	1099-G 86	1099-H 71	1099-INT 92
☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
1099-K 10	1099-LTC 93	1099-MISC 95	1099-OID 96	1099-PATR 97	1099-Q 31	1099-R 98	1099-S 75	1099-SA 94	3921 25	3922 26	5498 28	5498-ESA 72	5498-SA 27
☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

Return this entire page to the Internal Revenue Service. Photocopies are not acceptable.

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ **Title ▶** **Date ▶**

Instructions

Reminder. The only acceptable method of filing information returns with Enterprise Computing Center—Martinsburg (ECC—MTB) is electronically through the FIRE system. See Pub. 1220, Specifications for Filing Forms 1097, 1098, 1099, 3921, 3922, 5498, 8935, and W-2G Electronically.

Purpose of form. Use this form to transmit paper Forms 1097, 1098, 1099, 3921, 3922, 5498, and W-2G to the Internal Revenue Service. Do not use Form 1096 to transmit electronically. For electronic submissions, see Pub. 1220.

Caution. If you are required to file 250 or more information returns of any one type, you must file electronically. If you are required to file electronically but fail to do so, and you do not have an approved waiver, you may be subject to a penalty. For more information, see part F in the 2011 General Instructions for Certain Information Returns.

Who must file. The name, address, and TIN of the filer on this form must be the same as those you enter in the upper left area of Forms 1097, 1098, 1099, 3921, 3922, 5498, or W-2G. A filer is any person or entity who files any of the forms shown in line 6 above.

Preaddressed Form 1096. If you received a preaddressed Form 1096 from the IRS with Package 1096, use it to transmit paper Forms 1097, 1098, 1099, 3921, 3922, 5498, and W-2G to the Internal Revenue Service. If any of the preprinted information is incorrect, make corrections on the form.

If you are not using a preaddressed form, enter the filer's name, address (including room, suite, or other unit number), and TIN in the spaces provided on the form.

When to file. File Form 1096 as follows.

- With Forms 1097, 1098, 1099, 3921, 3922, or W-2G, file by February 28, 2012.
- With Form 5498, file by May 31, 2012.

Where To File

Send all information returns filed on paper with Form 1096 to the following:

If your principal business, office or agency, or legal residence in the case of an individual, is located in	Use the following three-line address
Alabama, Arizona, Arkansas, Connecticut, Delaware, Florida, Georgia, Kentucky, Louisiana, Maine, Massachusetts, Mississippi, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Texas, Vermont, Virginia, West Virginia	Department of the Treasury Internal Revenue Service Center Austin, TX 73301

Alaska, California, Colorado, District of Columbia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maryland, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, North Dakota, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Utah, Washington, Wisconsin, Wyoming	Department of the Treasury Internal Revenue Service Center Kansas City, MO 64999

If your legal residence or principal place of business is outside the United States, file with the Department of the Treasury, Internal Revenue Service Center, Austin, TX 73301.

Transmitting to the IRS. Group the forms by form number and transmit each group with a separate Form 1096. For example, if you must file both Forms 1098 and 1099-A, complete one Form 1096 to transmit your Forms 1098 and another Form 1096 to transmit your Forms 1099-A. You need not submit original and corrected returns separately. Do not send a form (1099, 5498, etc.) containing summary (subtotal) information with Form 1096. Summary information for the group of forms being sent is entered only in boxes 3, 4, and 5 of Form 1096.

Box 1 or 2. Complete only if you are not using a preaddressed Form 1096. Make an entry in either box 1 or 2; not both. Individuals not in a trade or business must enter their social security number (SSN) in box 2; sole proprietors and all others must enter their employer identification number (EIN) in box 1. However, sole proprietors who do not have an EIN must enter their SSN in box 2. Use the same EIN or SSN on Form 1096 that you use on Forms 1097, 1098, 1099, 3921, 3922, 5498, or W-2G.

Box 3. Enter the number of forms you are transmitting with this Form 1096. Do not include blank or voided forms or the Form 1096 in your total. Enter the number of correctly completed forms, not the number of pages, being transmitted. For example, if you send one page of three-to-a-page Forms 1098 with a Form 1096 and you have correctly completed two Forms 1098 on that page, enter "2" in box 3 of Form 1096.

Box 4. Enter the total federal income tax withheld shown on the forms being transmitted with this Form 1096.

Box 5. No entry is required if you are filing Form 1098-T, 1099-A, or 1099-G. For all other forms, enter the total of the amounts from the specific boxes of the forms listed below.

Form W-2G	Box 1
Form 1097-BTC	Boxes 1a, 1b, 1c, and 1d
Form 1098	Boxes 1 and 2
Form 1098-C	Box 4c
Form 1098-E	Box 1
Form 1099-B	Boxes 2 and 14
Form 1099-C	Box 2
Form 1099-CAP	Box 2
Form 1099-DIV	Boxes 1a, 2a, 3, 8, and 9
Form 1099-H	Box 1
Form 1099-INT	Boxes 1, 3, and 8
Form 1099-K	Box 1
Form 1099-LTC	Boxes 1 and 2
Form 1099-MISC	Boxes 1, 2, 3, 5, 6, 7, 8, 10, 13, and 14
Form 1099-OID	Boxes 1, 2, and 6
Form 1099-PATR	Boxes 1, 2, 3, and 5
Form 1099-Q	Box 1
Form 1099-R	Box 1
Form 1099-S	Box 2
Form 1099-SA	Box 1
Form 3921	Boxes 3 and 4
Form 3922	Boxes 3, 4, and 5
Form 5498	Boxes 1, 2, 3, 4, 5, 8, 9, 10, 12b, 13a, and 14a
Form 5498-ESA	Boxes 1 and 2
Form 5498-SA	Box 1

Final return. If you will not be required to file Forms 1097, 1098, 1099, 3921, 3922, 5498, or W-2G in the future, either on paper or electronically, enter an "X" in the "final return" box.

Corrected returns. For information about filing corrections, see the 2011 General Instructions for Certain Information Returns. Originals and corrections of the same type of return can be submitted using one Form 1096.

7373 ☐ VOID ☐ CORRECTED

CORPORATION'S name, street address, city, state, ZIP code, and telephone no.		1 Date of sale or exchange	OMB No. 1545-1814 **2011** Form **1099-CAP**	**Changes in Corporate Control and Capital Structure**
		2 Aggregate amount rec'd* $		
		3 No. of shares exchanged	4 Classes of stock exchanged	**Copy A For Internal Revenue Service Center**
CORPORATION'S federal identification no.	SHAREHOLDER'S identification no.			**File with Form 1096.** For Paperwork Reduction Act Notice, see the **2011 General Instructions for Certain Information Returns.**
SHAREHOLDER'S name				
Street address (including apt. no.)		5		
City, state, and ZIP code				
Account number (see instructions)		* The shareholder cannot claim a loss based on the amount in box 2.		

Form **1099-CAP** Cat. No. 35115M Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

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