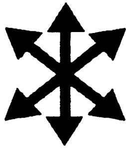
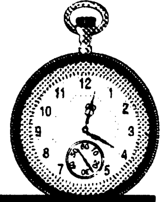


De Filipps'

DEALER TAX WATCH



A Quarterly Update of Essential Tax Information

Volume 3, Number 1 Publisher: Willard J. De Filipps, C.P.A. March 1996

DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?"...Here's what I'd say:

#1. IRS AUDITS. April 15th is now behind us. Some agents have used up all of their excuses about how the recent "Government shutdowns" affected their timetables and their ability to function more efficiently, so you can now expect the audit pace to pick up.

What's beginning to come up in "casual" conversation with some agents is their concern that certain transactions or results do not "clearly reflect income." This concern, when expressed as a standard by which our clients transactions will be measured, brings in a whole array of problems and arguments in which the IRS generally has the upper hand. This standard is gradually being extended from inventory cases where methods of accounting are involved to other areas of the audit.

The AICPA and many practitioners continue to be alarmed by the "threat" posed by the 27 lifestyle questions which comprise the backbone of what the IRS is now calling its "financial status analysis audit techniques." Some of these CPAs are also concerned over the (mal)practice implications. See Update on page 5.

INVITATION TO READERS: If you will share your experiences and/or concerns in current dealership audits—especially arising in connection with these economic reality audits—we will compile and communicate them to both the AICPA Working Group and to the IRS. We'd like to be proactive in this matter, where possible.

#2. IN ADDITION TO IRS ON-GOING AUDITS, other evidence of the IRS in action includes its recent releases of worker classification guides (see Update item #6), Coordinated Issues Papers involving intangibles, especially non-compete agreement amortization (see page 19) and the release of a document on emerging issues for auditors examining partnerships (see page 6).

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#3. DEALERSHIP BUY-SELLS, BLUE SKY, CONSULTING AND NON-COMPETE AGREEMENTS. In this ***Dealer Tax Watch***, our primary focus is on how the IRS and the Internal Revenue Code treat intangibles and allocations of amounts assigned to them by the buyer and seller in buy-sell negotiations. Part of our coverage updates you on the recent decision in the Tax Court (TCM 1996-21) involving Heritage Auto Center, Inc. This case involved a pre-1993 year. The second part of our coverage analyzes the two operative code sections: the more recently

LOOKING FOR ADDITIONAL & "VALUE ADDED" SERVICES FOR DEALER CLIENTS?

Look no further... Just use the *Dealer Tax Watch* for a head start in golden consulting opportunities and activities to help dealer clients—and, in the process, to help yourself.

see **DEALER TAX WATCH OUT**, page 2

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enacted Section 197 which affects mid-93 and after and Section 1060 enacted as part of the Tax Reform Act of 1996, with which Section 197 significantly overlaps. The third part of our coverage looks at the recently released (February 19, 1996) Coordinated Issue Paper on "Covenants Not to Compete."

As a followup to our prior review of ***Heritage Auto Center, Inc.*** when it was a case pending in the Tax Court, in January, 1996, the Tax Court issued its opinion. It was a real setback for the buyers. The Court allowed the purchasing dealership deductions amounting to $400 per year—for three years—a total of $1,200 in all—instead of the $675,000 they were claiming for deductible consulting fees. Do you need more proof that the IRS looks closely at these things?

Heritage Auto Center, Inc. involved two important elements: (1) the deductibility of reasonable consulting fees and (2) the economic reality and valuation of the seller's agreement not to compete. In this regard, ***Heritage*** involved the buying dealership's ability to amortize payments for a non-compete agreement under the "old law"—before it was changed in 1993. Under Section 197, which now applies, amounts paid for intangibles such as goodwill, going-concern value and non-compete agreements of whatever stripe or color **must** be amortized over a 15-year period, on a straight line basis. The allowance of amortization for goodwill and going-concern obviously, is a real break, since previously it was capitalized and forever forgotten. However, the Internal Revenue Code's lumping of covenants not to compete in with "goodwill and going-concern value" is clearly a set-back for buyers who are anxious to get as much in the way of deductions up front as possible.

Coincidentally, the IRS earlier this quarter released (February, 1996) its Coordinated Issue Paper on Covenants Not to Compete. This paper discusses the various circumstances under which challenges to contract allocations will be made and the various tests ("economic reality," "mutual intent," "strong proof" and the "Danielson rule") that the IRS applies. The current IRS examination position overlaps considerations both before and after the enactment of Section 197...and it may not be unusual to find the IRS now arguing the position that taxpayers previously took that a larger amount should be allocated to the non-compete agreement.

It now appears that consulting contracts—generating ordinary and immediately taxable income to the selling dealer, while at the same time generating ordinary and immediate tax deductions for the purchasing dealership—warrant greater emphasis in negotiations regarding allocations of selling price to specific assets and intangibles. Coverage of these areas, other observations, a look form at Form 8594 and bibliographies if you need to do further research on Code Sections 197 and 1060 round out our coverage.

#4. LIFO UPDATE IN A NUTSHELL: Not much new on conformity right now, a few other odds and ends for you to be aware of, with more detailed coverage in the March, 1996 issue of our sister publication, the ***LIFO Lookout***.

LIFO financial statement conformity requirements. We told readers that we were going to leave the conformity requirements alone for a while...until the IRS and NADA finalize their respective positions on a document expected to be released soon. This will require dealers and CPAs to self-police and confess their own LIFO conformity violations...and pay the tax on them, as well.

Expect something soon...Expect it to be unpleasant...Don't blame NADA if you don't like what comes when it gets here. The IRS has been sitting on this for a long time now and the Revenue Procedure will be a bombshell for some dealers and CPAs. Hopefully, you won't be one of them. We'll keep you up-to-date, you can be sure.

Other subjects covered in the March, 1996 *Lookout* included a tax return proforma reporting package for extending LIFO to used vehicles, a comparison of our new items report for 1995 calendar year dealers with that of the IRS, and a review of ***Kohler Co. and Subs***, a case in the U.S. Court of Federal Claims where the IRS again successfully overturned a taxpayer's use of LIFO in connection with a bargain purchase inventory at a substantial—50%—discount.

Reminder: there's a new Form 970 now with a December, 1995 revison date.

#5. CASES WE'RE WATCHING OUT FOR. On the horizon are two pending dealership cases we are watching and waiting to cover in future issues. The first involves the U.S. Court of Appeals, 9th Circuit, affirmation of the Tax Court's decision involving *William Wright, et. Al.* (TC Memo 1993-328). The Appeals Court upheld the Tax Court and the IRS that the corporation formed by the dealer was a sham for the purpose of avoiding taxes on income earned by the dealer and his dealerships. The Court also upheld the IRS that the understatements of income were fraudulent, that the amounts deducted for compensation were excessive and that other transactions had the (undesirable) consequences which the IRS believed they should.

The second "case" involves Tax Court Docket No. 27308-92 (*E.W. Richardson v. Commissioner*) in →

which the two major areas are extensive challenges to LIFO computations (which the ***Dealer Tax Watch*** will leave for the ***LIFO Lookout*** to cover) and challenges to the deductions claimed by the dealership in connection with its owning and operating of a Lear jet (which we will cover). At the present time, the Tax Court has not reported its decision in this case and we will await that, rather than commenting on the IRS' Reviewed Brief.

#6. WORKER CLASSIFICATION. Every year, controllers are reminded that Forms 1099 need to be sent to all independent contractors providing services to dealerships, if payments of more than $600 have been made and the providers were individuals or unincorporated businesses. Corporations are exempted from receiving Forms 1099. A prior issue of the ***Dealer Tax Watch*** (March, 1995) focused on the worker classification issue and *Martin L. Springfield d/b/a Douglas Motors* which involved a used car dealer who treated some workers as if they were independent contractors, rather than employees. This dealer was tripped up because the District Court found that the salespeople involved were actually employees and the dealer was not able to get relief or protection under Section 530.

That dealer had hoped to show that he could meet the so-called "reasonable basis" test because he had relied upon "industry practice."

The IRS recently—February, 1996—released an updated training guide entitled *Employee or Independent Contractor?* This training manual contains numerous examples involving trucking companies and other businesses. However, there are no examples in this 126-page document that specifically relate to automobile dealerships. The *Martin L. Springfield* case, mentioned above, seems to be the only reference to dealers, and is found on page 3-24 of that document.

On your behalf, I read the whole training guide looking for some interesting or some juicy tidbits to report...but found none...so save your time looking for anything more dealer-specific here.

#7. UPCOMING CONFERENCES OF INTEREST TO DEALERS' CPAS.

AICPA'S Third National Auto Dealership Conference. We've barely finished telling you about the last convention, and now the third one is scheduled for Phoenix, on October 21-22. Both the IRS Motor Vehicle Specialist, Bob Zwiers, and NADA's Pete Kitzmiller will be on the agenda, along with a variety of other informative speakers and topics. Mark your calendars now and make your plans travel accordingly.

***Car Dealer Insider* sponsors "Survive & Thrive Beyond 2000" at the Capital Hilton Hotel in Washington, DC on April 29-30.** Coverage includes a number of presenters discussing current valuation issues, dealership value protection strategies and the more intimidating aspects of the Factories "projects" to realign dealerships. We have received calls from several CPAs who are working with the complex tax ramifications of trying to spin off or spin out various franchise activities and operations at the Factories behest or in response to their insistence. These CPAs are getting a good workout in Section 355 and other reorganization provisions which they have not had to cope with for some time.

We previously sent information to you on the special discount for the "Survive & Thrive Beyond 2000" seminar that we were able to arrange for subscribers to our publications and members of our Dealer/CPA 21 Resource Groups. We hope to see you in Washington.

#8. PUBLICATIONS OF INTEREST TO DEALERS' CPAS

Money on the Table. One of the benefits of attending the NADA Convention each year is that you meet other folks who are actively working in their own specialized niche areas serving automobile dealers. I met John Mailho at the NADA Convention in Las Vegas and he, in turn, made me aware of a book on after-market compensation techniques (including reinsurance, insurance company taxation and domicile selection) that he and an associate recently wrote.

This book discusses credit life and disability insurance, front commissions, retroactive compensation, reinsurance, the U.S. regulatory environment, Arizona and Turks and Caicos Islands reinsurers, direct writer considerations, vehicle service contracts and other after-market sales opportunities. This book also includes a chapter on Federal income taxation which is intended to provide a general overview of the tax structure for insurance companies as of late 1992.

This book, like *Automotive Dealership Accounting* described below, is suggested for your consideration as a good reference to help with understanding the specialized language and *modus operandi* within the auto dealer niche market.

Automotive Dealership Accounting was recently released by the AICPA as a self-study continuing education course for CPAs with auto dealer clients. The material, written by Jacob Cohen and Carl Woodward, provides a general background familiarizing readers with dealership terminology, spe-

see **DEALER TAX WATCH OUT,** page 4

 (Continued from page 3)

cialized asset, liability and owner equity accounts, and a review of various departmental activities. Departments covered include new vehicle, used vehicle, finance insurance and after-sale products, parts, service, body shop, lease and rental and buy-here, pay-here.

Two chapters are included on specific income tax issues and succession planning. The former discusses—but only in a very general way—choice of entity, accounting methods, inventory methods, demonstrator vehicle requirements and includes checklists and practice guides. The chapter on succession planning for auto dealerships discusses exit strategies and selected techniques or devices including buy-sell contracts, redemption agreements, private annuities and other arrangements.

Appendix materials include Ford and General Motors financial statements, sample review statements and other materials.

The AICPA's *Auto Dealership Engagement Manual—1995 Revision* has apparently reached the end of its trail as an AICPA publication. It appears this reference will now become available through Practitioners Publishing Company (PPC), out of Ft. Worth, Texas.

#9. CATCHING UP ON SOME 1996 NADA CONVENTION WORKSHOPS. You may want to listen to the tapes of the Convention workshop presentations by Pete Kitzmiller and by Dave Duryee.

Kitzmiller's "Update on IRS Regulations" overviewed the LIFO conformity requirements for dealers' financial statements, Technical Advice Memos 9535009 and 010 and NADA's efforts (yet to bear *bitter* fruit) to resolve the conformity issue with the IRS. Other tax areas he covered related to the IRS audit program involving demonstrator vehicles including the four major issues of (1) the $3 a day commuter rule, (2) recordkeeping by salespersons, (3) valuation of the demonstrator vehicle for purposes of determining additional taxable income to the user and (4) the salesperson exemption as it applies to sales managers.

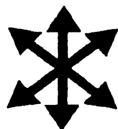
Kitzmiller also advised dealers to be sure they are currently computing the luxury tax correctly where the negotiated selling price exceeds $34,000 and properly handling the taxability of lease acquisition fees, and he reminded dealers about recent Letter Rulings 9423004 and 9525003 dealing with withholding on manufacturer incentive payments to sales people. Finally, he touched on various tax problems arising in connection with dealer-owned insurance companies, whether they be Arizona domiciled—or offshore—and the activity of the IRS as evidenced by *Wright v. Commissioner*. (See Update comment #5.)

Dave Duryee's presentation, "Current Valuation Issues for Succession Planning," is well worth your listening time as he presents very insightful observations as well as specific information on discount techniques, minority interest discounts and non-marketability discounts, the use of non-voting stock and ramifications where limited liability company and/or family limited partnerships are in use.

With respect to stockholder agreements, his five rules are:

1. **Have one.**
2. **Read it.**
3. **Understand every word.**
4. **Prepared only by an experienced lawyer.**
5. **Know where it is and review it every year.**

This little gem, says a lot. Along with many others, it rewards your listening time and gives you great ideas for value added consultations with your dealer clients.



De Filipps' DEALER TAX WATCH
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IRS "ECONOMIC REALITY" AUDITS A/K/A "FINANCIAL STATUS" AUDITS...AN UPDATE

In the June, 1995 ***Dealer Tax Watch*** (page 6), we discussed the "hail of controversy" raised at the AICPA Tax Division meeting last year in connection with the IRS' "economic reality" audits and the infamous **Lifestyle questions** agents were encouraged to ask taxpayers directly. The whole thrust here is to have the agent attempt to match up a "sense" of the taxpayer's lifestyle and economic reality with the sometimes meager results reported on the 8½ x 11 tax return forms. As pointed out elsewhere in the ***Tax Watch***, agents have been encouraged to adopt a variety of means by which to "size up" the taxpayer in this regard. Helpful suggestions, peppered in various IRS audit manuals and other training documents, include: "...drive by the dealer's residence to see what's parked in the driveway."

These audits and Economic Reality questions are now referred to as "financial status analysis audit techniques." The American Institute of CPAs is still up in arms and a special Task Force has advised AICPA members to resist the IRS agents where appropriate in connection with their desire to interview the taxpayer without the CPA/representative present.

All of our accounting newspapers and newsletters have covered this with stories of various degree. Two more detailed articles include the one in the March, 1996 *Practical Accountant*: "IRS Audits Digging Deeper Beneath the Surface" by Arthur Fredheim and "AICPA Offers Guidance on IRS Financial Status Auditing" by the AICPA Tax Division Financial Status Audit Working Group in *The Tax Adviser*, April, 1996.

Perhaps the reason agents are not anxious for CPAs to "get in the way" and to keep the taxpayer away from direct contact with them during the audit is gleaned from the following statistics: When examiners work with only the taxpayer representative, the total time on the taxpayer examination averages 260 days. However, when the examining agents can work with the taxpayer **alone**, the cycle time was down by more than 50% to 115 days and working with the taxpayer and the representative together, the cycle time was 105 days. Do CPAs tend to procrastinate as much as examining agents in real audit situations?

see **IRS ECONOMIC REALITY AUDITS**, page 6

AICPA RECOMMENDATIONS

1. Obtain an engagement letter...which should include a request that the client sign a Power of Attorney (Form 2848) which will notify the IRS that the CPA is the client's authorized representative. The sample engagement letter illustrated for this purpose includes the statement by the CPA to the client that "we believe that it is in your best interests to refer any questions or other contact from the agent to us without discussing the case with the agent. By signing this engagement letter, you acknowledge that any direct contact by the Internal Revenue Service will be referred to us as your authorized representative. It is hereby acknowledged that **<u>if you choose to appear before, or discuss this case with, the agent against our advice, you do so at your own risk</u>**." Emphasis added.
2. Before the initial conference with the agent, request the IRS file containing any information or documents accumulated by the agent during the "pre-audit investigation." In a memorandum last year, the IRS Assistant Commissioner (Examination) told IRS agents that taxpayers and representatives should be provided with available third-party information on request, <u>except for informant information</u>.
3. The CPA should perform a "pre-audit" evaluation of the client's overall situation. This evaluation should not include questioning the taxpayer about unreported income, but instead should be based on a review of the tax return and incorporate what the CPA knows about the client's lifestyle and the adequacy of the client's recordkeeping.
4. Attend the initial...and subsequent...interview **<u>without</u>** the taxpayer.
5. Challenge the reasons for the financial status questions.
6. React to the agent's persistent questions. This reaction may, or could, become contentious. To protect both the CPA and the client, because of the lack of a CPA-client privilege, the CPA may advise the agent that he may recommend that the client wait for an Administrative Summons under Section 7602 to be issued.
7. Refrain from discussing financial status questions.
8. Wait for an Administrative Summons.
9. Recommend legal representation.

EMERGING PARTNERSHIP ISSUES OF SPECIAL INTEREST TO DEALERS

The greatest challenge to CPAs in planning for auto dealers and their families and for their dealerships is the fact that there are so many different ways to be creative and so many entities from which to choose. It's just so much fun out there with all those choices.

The choice of the entity (whether regular corporation, C or S for tax purposes, limited liability company or limited liability partnership)...gets more complicated with management company, holding company and/or consolidated return possibilities. "Brother-sister" groups, affiliated groups, trusts...even ESOPs...are there for the choosing and using.

Various techniques when a dealer reaches the point where phasing out and easing out get talked about include buy-sell contracts, private annuities, GRITS, GRATS and GRUTS, with special emphasis on the grantor retained annuity GRAT trusts—as well as recapitalizations and self-canceling installment notes.

Amid all these "options" and buzz words, many CPAs feel that the best one of all still is the good old fashioned **PARTNERSHIP**...that's the entity where you file a Form 1065 and from which the original term "K-1" (referring to Subchapter K in the Internal Revenue Code) comes. Partnerships are especially useful when the dealership real estate is not owned by the corporation and varied family interests...not to mention personalities...are involved.

A recent IRS internal publication entitled "Decoding Subchapter K" identified several emerging partnership issues that IRS agents should be alert to look into.

- **Most significantly, in the area of family limited partnerships, discounts in estate and gift planning under Section 704(e).**
- Abuses under the partnership anti-abuse rules of Reg. Sec. 1.702-2.
- Disguised sale rules of Section 707(a)(2)(B).
- Allocations under Section 704(b).
- Sections 704(c) and 737—five year, fair market value, annual allocations, and adjusted basis rules.
- Allocation of payments between Section 736(b)(3) and Sections 736(a) and (b).
- Partnership versus joint venture filing requirements under Section 761 and 6031.
- Recourse liabilities under Section 1.752-2 on capital account restoration obligations, and qualified and non-qualified liabilities.
- Non-recourse liabilities under Section 1.752-3 on minimum gain under Section 704(b), minimum gain under 704(c), and excess liability.
- Cancellation of indebtedness income from relief of Section 108 and partnership liabilities under Section 61(a)(12).

IRS Economic Reality Audits

(Continued from page 5)

In a recent commentary, William and Burgess Raby stated: "To be blunt, the AICPA fears that these (audits) will result in tax controversy work formerly handled be CPAs being driven into the hands of lawyers." What do you think?

Are you experiencing any undue difficulties with IRS agents auditing your dealerships and applying these "financial status analysis audit techniques?" *The Tax Adviser* article states that "the only role for a CPA in a criminal tax fraud case is in support of an attorney that has expertise in criminal tax law and the advantage of privileged communications with the taxpayer." Are you feeling unduly boxed in by these audits? Do you agree with this?

CPAs are about to see what possible silence on real tax issues will "cost" them when the IRS issues its "solution" to dealer's LIFO conformity problems. Let's not make the same mistakes all over again.

TAX COURT CLOBBERS
BUY-SELL ALLOCATIONS AND DEDUCTIONS
HERITAGE AUTO CENTER, INC. ...T.C. MEMO 1996-21

In the September, 1995 ***Dealer Tax Watch***, we discussed the IRS' Reviewed Brief submitted in connection with *Heritage Auto Center, Inc.*, then docketed in the Tax Court (26362-92). The case involved the IRS' disagreement with the buyer's allocation of $1,350,000 worth of "excess" of price over hard assets which was to be allocated among:

- Goodwill...blue sky...franchise or going concern value,
- Agreement not to compete, and
- Consulting agreement.

In Tax Court Memo Decision 1996-21 (January 23, 1996), the result was that overall only 25% of what the buyer thought it should have been able to write off over three years was actually allowed. The remaining 75%—slightly over $1,000,000—was treated as non-amortizable, non-deductible goodwill.

At the time the buyer/petitioner, *Heritage Auto Center, Inc.*, purchased the assets of the Ford, Toyota and Suzuki franchises (collectively, the Totem Lake Dealerships) from Mr. William T. Wright, the four shareholders of the purchasing corporations had just over 100 years of combined auto dealership experience. The least experienced of the four purchasing shareholders had 20 years experience, and the most experienced had 30 years, including several positions with Ford Motor Company. Prior to the sale, the seller had suffered adverse publicity in the metropolitan Seattle area as a result of being accused of consumer fraud by the Attorney General of the State of Washington in connection with some local advertising. Mr. Wright and his dealership had executed a consent degree under which they were enjoined from participating in certain advertising, sale, repair and servicing automobile activities. Local press coverage was intense and additional lawsuits were eventually brought by the Attorney General alleging fraudulent sales practices. Disgruntled customers picketed the dealerships; former employees filed complaints, and the dealerships—which had previously been "very profitable"—sustained losses in 1986 and 1987.

As noted above, one of the purchasing shareholders in the purchasing group had previously been with Ford Motor Company and had received a call from the Western Regional Manager of Ford Motor Company indicating that the Totem Lake Dealerships were in severe financial trouble and that Ford wanted this individual and his associates to consider purchasing the dealerships. After an initial meeting, in which the purchasers rejected Mr. Wright's initial offer, subsequent negotiations ensued principally between Mr. Wright (as the seller) and Mr. Richardson (on behalf of himself and the other eventual buyers). The record indicates that there were several unsuccessful discussions, but eventually, a deal was struck—or at least an agreement in principle was reached. The attorneys then took over and the principals and their attorneys met to discuss the details. The buyer's attorney's meeting notes contained the notation "$1,350 K blue sky covenant and goodwill." The sellers' attorney's note from the meeting included "$1,350,000 Blue or covenant not to compete."

On March 4, 1988, the buyers entered into an agreement to purchase the assets of the two Washington corporations owned by Mr. Wright. The purchase agreement provided that $200,000 would be paid for goodwill and that the "Seller will preserve for Buyer the goodwill of the Dealerships, including the goodwill of its suppliers, customers and others having business relations with the Dealerships." The non-competition agreement attached to the purchase agreement provided $1,150,000 would be paid to Mr. Wright at closing for his agreement not to compete with the buyers for a period of three years. The allocation of $200,000 to goodwill and $1,150,000 to the covenant not to compete was reached by Mr. Richardson (one of the shareholders in the acquiring corporation) and by Mr. Wright; the other purchasers and their attorney all testified that they did not know the basis of these allocations, since none of them were involved in this part of the negotiations.

In a letter dated March 7, 1988, the seller's attorney told the purchaser's attorney that the parties would readjust the goodwill/covenant not to compete if it is determined that the manner of the allocation is not in the best interest of Mr. Wright, the seller. The letter (from the seller's attorney) also stated that it was recognized that "as far as this allocation is concerned, your client desires to have at least $100,000 applied to goodwill and does not desire to have a great deal more applied to goodwill."

Shortly after that, in a letter dated April 7, 1988, the seller's attorney sent the buyer's attorney a draft agreement which reflected new terms: $675,000 payable on closing for a covenant not to compete and $675,000 (payable in three equal annual installments of $225,000) for Mr. Wright's employment as a consultant for a period

see **TAX COURT CLOBBERS BUY-SELL PRICE ALLOCATIONS...**, page 8

 (Continued from page 7)

of three years. Furthermore, the buyers would also pay Mr. Wright a fee of $1,000 per day, for consultation either in person or by telephone.

The purchaser's attorney's reply with respect to the consulting portion of the draft agreement was to suggest that (1) a sentence be added allowing the buyer to prepay the consulting fee at any time without penalty and (2) that, among other things, the entire paragraph calling for the $1,000 per diem consulting payments be deleted. The buyer's attorney commented that the "inclusion of additional consulting fees, especially at this high rate, makes the $675,000 fee look like a sham, and endangers its deductibility."

After these exchanges of correspondence, the parties entered into an addendum amending the purchase agreement which provided that no portion of the purchase price related to goodwill and that "all goodwill of the business of (the) seller is not to be assigned any value." Note that this expressly acknowledged the existence of goodwill; it simply provided that that goodwill would be assigned no value.

NON-COMPETE AGREEMENT

The final agreement provided that the seller would be paid $675,000 at closing in exchange for his covenant not to compete for a period of three years. Specifically, the seller agreed not to compete with the buyers, directly or indirectly, either as an employer, employee, consultant, agent, officer, director, shareholder, or owner of any entity, for a period of three years in the business of retail sale or repair of Toyota, Ford or Suzuki automobiles. The seller also owned a low volume Chevrolet-Nissan dealership in the same metropolitan area, but the terms of the consulting agreement and non-compete agreements did not prevent him from continuing to operate that Chevrolet-Nissan dealership.

The seller further agreed not to solicit or otherwise encourage any present or future employee of the buyers to perform work in auto sales or repairs for him for a period of three years. The covenant not to compete covered a radius of 50 miles around Kirkland, Washington. The $675,000 to be paid for the covenant not to compete was "not reimbursable in the event of the death or disability of Mr. Wright."

The buyers indicated that they believed the non-compete agreement was necessary because they were concerned that Mr. Wright might recruit employees from the Totem Lake Dealerships to work in his Chevrolet-Nissan dealership. In addition, they were concerned that he might obtain employment from one of the 21 Ford dealerships or 19 Toyota dealerships in the Seattle, Washington area where he could use his industry contacts and experience to the detriment of the buyers.

CONSULTING AGREEMENT

The final agreement for consulting services called for a total of $675,000 to be paid in three equal annual installments, which the buyers could prepay at any time without penalty. The entire amount was, in fact, paid at closing.

Mr. Wright's obligation to consult was limited to a maximum of 5 days per month, not to exceed 15 days per calendar quarter, and his right to receive $225,000 per year under the consulting agreement was both absolute and unconditional.

The buyers indicated that they believed the consulting portion of the agreement was necessary because of their need for Mr. Wright's assistance and experience in dealing with Toyota, the non-domestic manufacturer.

After the sale, the general manager of the purchasing dealership did consult with Mr. Wright twelve times regarding problems they were having with Toyota, although each conversation lasted less than 20 minutes. In addition, Mr. Wright also consulted with the buyers relative to various financial institutions in the Seattle area.

The findings of fact indicate that although some time between March 7, 1988 and the finalization of the agreements the parties changed their purchase price allocations, the buyers (except for Mr. Richardson) and their attorney did not know how these changes came about. One of the buyers specifically stated that he thought there shouldn't be any goodwill: "I mean, there was just the opposite."

AFTER THE SALE

Heritage Auto Center, Inc. was formed on or about March 10, 1988 and the four individual buyers assigned their interests in the purchase agreements to Heritage and to Heritage Suzuki, Inc., another corporation. New dealership franchises were obtained from Ford, Toyota and Suzuki. Disgruntled customers who had been picketing the Totem Lake Dealerships stopped picketing the day the new owners took over. After operating the Suzuki franchise for about 10 months, that franchise was terminated in early 1989 and that facility was used primarily for repair services and the sale of parts and used vehicles. →

The Form 8594, Asset Acquisition Statement Under Section 1060, filed by Heritage as part of its 1988 tax return, reported $675,000 as the amount paid for the covenant not to compete and $675,000 as paid for the consulting agreement, which amounts were represented to be the fair market value of intangible, amortizable assets with useful lives of three years. Heritage claimed deductions for amortization consistent with these representations.

WHAT THE TAX COURT SAID

In its opinion, the Tax Court lumped everything together and summarized the issue concisely: "Whether the final agreement is amortizable."

Just as simply, the Tax Court said the payments were, in substance, payments for the sale of non-amortizable goodwill or going-concern value. The Court pointed out that goodwill has been defined as "the expectancy that old customers will resort to the old place of business" and that going-concern value is similar to goodwill in that it reflects "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern."

The Court laid out the parity of the tax treatment as follows: Amounts paid by a buyer for goodwill or going-concern value result in capital gain to the seller, with the buyer acquiring an intangible asset that may not be amortized. Note that for transactions involving the acquisition of intangibles occurring after August 10, 1993, Code Section 197 now provides for a 15-year amortization period for acquired intangible assets, including goodwill and going-concern value. The *Heritage* case involved an acquisition before new Code Section 197 became operative.

Amounts paid by a corporation for services, including consulting services, are includable as ordinary income by the dealer as the service provider and are deductible...to the extent **reasonable**...by the purchasing corporation. Similarly, amounts paid by a buyer for a covenant not to compete require ordinary income treatment, since they represent a substitute for ordinary income to the covenantor. Payments for a covenant not to compete may be amortized by the buyer over the useful life of the covenant.

The economic substance of a transaction, rather than the form in which it is cast, is controlling for Federal income tax purposes. Accordingly, the Courts may—and often do—pierce the form of the transaction and tax the substance. The burden of proving that the form of a transaction should be respected is on the taxpayer. See page 12 for IRS challenges to Heritage's purchase price allocation and page 13 for factors the courts typically consider.

Generally, a contractual allocation will be upheld if it has "economic reality," i.e., some independent basis in fact or some arguable relationship with business reality so that reasonable persons might bargain for such an agreement. Obviously, it is necessary to examine the facts and circumstances of each particular case in order to determine whether a contractual allocation has "economic reality."

Where this issue arises, the Courts will give more deference to the form of the agreement between the parties <u>if the parties to the contract have adverse tax interests</u>. The rationale is simply that where the tax avoidance or minimization desires of the buyer and the seller are opposite each other, that forces them to agree to a treatment which reflects their true intent with reference to the covenants and to true values in monetary terms.

Where there is a difference between the tax rate applied to ordinary income and to capital gains, the tax interests of buyers and sellers in allocations between goodwill and covenants not to compete or consulting agreements are antithetical (opposite). In such instances, sellers prefer allocations to goodwill because gain on a sale of goodwill is taxed more favorably as capital gain, whereas amounts received by the seller for a covenant not to compete are taxed as ordinary income. Buyers, in contrast, prefer allocations to covenants not to compete because amounts so allocated can be written off over the period covered by the covenant, whereas the cost of goodwill is not depreciable and produces no tax benefit until the goodwill is sold or lost. Note: Section 197 applies to transactions after August, 1993 and is discussed in a separate article.

For years in which capital gain and ordinary income are taxed at the same rates, sellers and buyers will generally lack tax adversity since sellers will be indifferent as to whether they will be required to recognize capital gain or ordinary income and, thereby, appear to have no tax stake in the buyer's allocation among goodwill, covenants not to compete or consulting agreements. Under pre-1993 law, buyers—on the other hand—would generally prefer to have allocations made to the covenant not to compete or to consulting agreements because payments for those agreements would generate more immediate tax deductions.

see **TAX COURT CLOBBERS BUY-SELL PRICE ALLOCATIONS...**, page 14

HERITAGE AUTO CENTER, INC.
SUMMARY TABLE: THE BOTTOM LINE
T.C. MEMO DECISION 1996-21; DOCKET NO. 26362-92 (JANUARY 23, 1996)

	Draft Agreement	Original Agreement March 4, 1988	Per Taxpayer Amended Agreement April 7, 1988	Per IRS Brief	Tax Court TCM 1996-21 Jan 23, 1996
Goodwill/Blue Sky/Franchise Value		$200,000	--	$1,350,000	$1,011,300
Agreement Not to Compete (Non-Compete Agreement)		1,150,000	675,000	--	337,500
Consulting Agreement			675,000	--	1,200
TOTALS	$1,350,000	$1,350,000	$1,350,000	$1,350,000	$1,350,000

On the tax returns of the buyer, Heritage Auto Center, Inc., the payments totaling $675,000 for the seller's covenant not to compete and seller's consulting agreement payments also totaling $675,000 were amortized over a 3-year period. On the financial statements of the buyer, the total amount of $1,350,000 was treated as goodwill subject to amortization based on a 40-year life. The $1,350,000 represents the amount paid over and above the amount paid for tangible assets ($1,964,300). Thus, the total purchase price was $3,314,300.

The taxpayer's Form 8594, Asset Acquisition Statement Under Section 1060, for the taxable year 1988 claimed the above $675,000 amounts as the fair market value of intangible amortizable assets with useful lives of three years purchased by it from the seller.

Heritage claimed amortization deductions of $225,000 per year (pro-rated on a monthly basis for 1988). The position of the IRS was that the entire amount ($1,350,000) was paid for non-amortizable assets and no deduction for amortization should be allowed.

Tax Court recognized only 25% ($338,700) as deductible over 3 years; the remaining 75% ($1,011,300) was capitalized as goodwill.

Note: Had these final results as determined by the Tax Court in *Heritage Auto Center, Inc.* occurred in a year subject to Section 197, the approximate results by year are shown in the accompanying table which illustrates the contrasting results.

HERITAGE AUTO CENTER, INC.

COMPARISON OF OLD LAW VS. SECTION 197 AMORTIZATION OF INTANGIBLES

	Per Tax Court Determination		Section 197 Allowable Amortization	
Year	Amount per Year	Cumulative YTD	Amount per Year	Cumulative YTD
1	(A) $112,900	$112,900	(B) $90,320	$90,320
2	112,900	225,800	90,320	180,640
3	112,900	338,700	90,320	270,960
4	-	338,700	(C) 89,920	360,880
5	-	338,700	89,920	450,800
6	-	338,700	89,920	540,720
7	-	338,700	89,920	630,640
8	-	338,700	89,920	720,560
9	-	338,700	89,920	810,480
10	-	338,700	89,920	900,400
11	-	338,700	89,920	990,320
12	-	338,700	89,920	1,080,240
13	-	338,700	89,920	1,170,160
14	-	338,700	89,920	1,260,080
15	-	338,700	89,920	1,350,000
TOTAL	$338,700	--	$1,350,000	--

Section 197, effective August, 1993, provides for the amortization of amounts allocated to goodwill, going-concern value and covenants not to compete (and other Section 197 intangibles) over a 15-year period.

As under prior law, amounts paid for consulting services under a consulting contract would be deductible to the extent they are paid for services actually rendered and to the extent the amounts paid are reasonable.

(A) = ($1,200/3 yrs. = $400/per year) + ($337,500/3 yrs. = $112,500/per year)...
Total per year $112,900 (A)

(B) = ($1,200/3 yrs. = $400/per year) + ($1,101,300 + 337,500 = 1,348,800/15 yrs = $89,920/per year)...Total per year $90,320 ($400 + 89,920)

(C) = ($1,101,300 + 337,500 = 1,348,800/15 yrs = $89,920/per year)

Comment: The difference between "winners" and "losers" under the old law is readily apparent from the above table. The amounts above are shown for a full 12-month year assuming a January 1 acquisition date. Actual payments must be amortized beginning with the month in the year during which the intangible is acquired.

IRS CHALLENGES TO PURCHASE PRICE ALLOCATIONS

1. The buyers had **no reasonable expectation** that the individual selling dealer would compete with them as a Ford, Toyota or Suzuki automobile dealer in the Seattle, Washington metropolitan area within 3 years of their purchase of the assets of the dealerships.
2. The risk that the individual seller would compete...(in that area...for that period of time)... was not significant.
3. At the time of the purchase of the assets, the franchises were valuable assets. Furthermore, they were intangible assets without an ascertainable useful life.
4. The buyers had a reasonable expectation that under new management and with new names, the dealerships that were purchased would be profitable again.
5. The buyers believed that the dealerships had going concern value or goodwill despite (or notwithstanding) the adverse publicity of the individual selling dealer and his dealerships.
6. The interests of the parties were not adverse with respect to the characterization of the $1,350,000 agreed to be paid in excess of the value of the tangible ("hard") assets.
7. The $1,150,000 allocated in the original purchase agreement to the covenant not to compete **did not comport with economic reality**.
8. The covenant not to compete had **no economic significance independent of** the going concern value or goodwill of the dealerships and the intangible value of the franchises.
9. The Addendum was entered into in order to pass more of the purchase price directly to the individual selling dealer and shareholder, rather than to his corporations.
10. At the time that the Purchase Agreement was executed, the **parties had no intention** that the individual seller would perform consulting services. Furthermore, the need for the buyer to consult with the seller was not significant. Additionally, there was **no reasonable expectation** that the buyers would need to consult with the seller for as much as 60 days per year, nor that they would need to consult with the seller for a period of three years.
11. The $675,000 amount allocated to the consulting agreement "**did not comport with economic reality**." It was an attempt to justify the amortization for tax purposes of the $1,350,000 agreed to be paid in excess of the amount paid for the tangible assets of the dealerships.
12. The $675,000 amount allocated to the consulting agreement in the Addendum **was not paid for anticipated consulting services**, but was paid as part of the purchase price of the assets for the dealerships.
13. Finally, the purchaser is **not entitled to amortize any part** of the $1,350,000 under Section 167.

FACTORS THE COURTS CONSIDER IN EVALUATING ECONOMIC SIGNIFICANCE OR ECONOMIC REALITY OF COVENANTS NOT TO COMPETE

Some 35 years ago, in *Schultz v. Commissioner*, the Court stated that "the covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned for their economic future, might bargain for such an agreement."

Over the years, the courts have considered many factors in determining whether non-compete covenants have independent, economic significance or economic reality. The absence of some of the factors, or the presence of the converse of such factors, weigh against the independent economic reality of a covenant not to compete. These factors are also cited in a number of IRS Reviewed Briefs involving the amortization of non-compete agreement payments under pre-Section 197 law.

1. The presence of a grantor of the covenant having business expertise evidencing a formidable capacity to compete.
2. The grantor's ownership of technology and/or machinery necessary to compete.
3. The grantor's possession of sufficient economic resources to compete.
4. The legal enforceability of the covenant not to compete for the term of the particular covenant under state law.
5. The grantor's legal capacity to compete.
6. A covenant having sufficient breath in scope to assure non-competition without overreaching.
7. The not-too-advanced age of the grantor.
8. The good health of the grantor - or the overall physical condition of the grantor.
9. Payments for the covenant not to compete that are not pro rata to the grantor's stock ownership in the selling entity.
10. The buyer's policing of the covenant not to compete.
11. Structuring the payments under the covenant not to compete to occur over time and to cease upon breach of the covenant, or upon death (or disability) of the grantor.
12. Vigorous negotiations over the covenant not to compete and negotiations over its value.
13. A detailed, specific and carefully drafted covenant not to compete.
14. An independent appraisal of the value of the covenant not to compete.
15. Some degree of reasonableness in the percentage of the consideration allocated to the covenant not to compete.

 (Continued from page 9)

The Tax Reform Act of 1986 eliminated the tax differential between capital gains and ordinary income and this lack of a tax rate differential affected the tax years involved in this case. Accordingly, the buyers and the seller (Mr. Wright) were not treated or recognized as having adverse tax interests when negotiating the allocations in question. Since the consulting agreement and the covenant not to compete were integrated into a single statement, the Tax Court considered them separately to determine whether the payments Heritage made actually were for the purposes set forth.

THE CONSULTING AGREEMENT BOMBS

The IRS had argued that the amount allocated to the consulting agreement lacked economic significance and was, in substance, a disguised payment for goodwill or going-concern value.

The Service also argued that with over a century of combined dealership experience (well, they didn't quite phrase it that way!) the shareholders of Heritage Auto Center, Inc. would have had little need to consult with the seller. These shareholders had extensive experience in the domestic and imported automobile dealership business, including experience with a Japanese manufacturer. However, they did not have experience in *dealing specifically with Toyota.* The buyers indicated that their consulting agreement with the seller had economic significance because they did need Mr. Wright's assistance in dealing with Toyota and that Mr. Wright had extensive knowledge and experience in dealing with this Japanese manufacturer. Furthermore, in fact, Mr. Wright did consult with the petitioners—however briefly—regarding Toyota.

The Court observed that neither Mr. Richardson nor Mr. Wright—the two individuals who were the principals in the agreement—testified. The Court commented that "the sparse evidence regarding the negotiation of the consulting agreement does not indicate that the agreement had economic substance." It further observed that the seller's right to receive $225,000 per year was absolute and unconditional and that absolute right indicated that the payment was not—in substance—for consulting services.

In examining events after the execution of the agreement, the Court found that the minimal number of consultations, coupled with the paucity of evidence regarding the nature, scope and value of such services, indicated that the allocation of $675,000 did not have an arguable relationship with business reality.

The Court did recognize that a reasonable buyer would pay some consideration for a consulting agreement with Mr. Wright...and accordingly, assigned the consulting agreement a value of $1,200 (no, that's not a misprint) which could be amortized over the 36-month term of the consulting agreement resulting in a whopping $400 per year. With respect to the remaining portion of the amount allocated to the consulting agreement (i.e., $673,800), the Court said simply "we affirm respondent's determination"—in other words, the IRS was right and this $673,800 represented goodwill to be capitalized.

COVENANT NOT TO COMPETE—GENERALLY, HALF A LOAF IS BETTER THAN NONE

In analyzing the non-compete agreement, the Court believed that the buyers were genuinely concerned that Mr. Wright might recruit employees from the dealerships to work in his other dealership. Furthermore, the Court said that it believed the buyers were concerned that Mr. Wright might obtain employment from one of the 40 Ford or Toyota dealerships in the area. If he were so employed, Mr. Wright would be in in a position where he could use his industry contacts and experience to the detriment of the buyers. These findings were probative of the economic substance of the covenant. Furthermore, said the Court, the covenant appeared to be genuinely, but realistically, restrictive insofar as it extended over a 50-mile area and did not extend beyond three years. These two factors lent credence to the economic significance, as well.

The Court observed that a reasonable person in the position of the buyers would likely bargain for a non-competition agreement from a seller. It noted further that although Mr. Wright's reputation might not be the best (in the words of the Tax Court, it was "tarnished"), the Court nevertheless believed that the buyers were genuinely concerned that Mr. Wright still might be or could pose a competitive threat. Taking into account the extensive adverse publicity that Mr. Wright had received, the Court believed that the allocation of $675,000 to the non-compete agreement was excessive and it found that the non-competition covenant had a value of only $337,500—one-half the amount claimed by the buyers. With regard to the remaining portion of the amount allocated to the covenant—i.e., the other $337,500—the Tax Court affirmed the IRS' determination that it should be treated as goodwill.

SECTION 197: AMORTIZATION OF INTANGIBLES IN BUY-SELL AGREEMENTS AFTER AUGUST, 1993

Both the Tax Court in *Heritage Auto Center, Inc.* and the IRS in its Coordinated Issue Paper on covenants not to compete (see page 19) referred to the "tension" between buyers and sellers as to their respective tax positions and treatments of payments in negotiating terms of a business sale. Prior to 1986, two factors created this tension: first was the differential in long-term capital gains rates versus tax rates on ordinary income and second was the existence of Code Section 337. As a consequence, the IRS generally recognized price allocations as having been made at arms-length by buyers and sellers in the absence of unusual or complicating circumstances.

In 1986, changes made by that year's Tax Reform Act, including the repeal of Section 337 and the leveling of ordinary income rates to match those on long-term capital gains resulted in the removal of the previously "adverse" positions of the buyer and the seller. Another provision in the Tax Reform Act of 1986 affecting the area of buy-sell agreements was Section 1060 which created special allocation rules for certain asset acquisitions. Under Section 1060, effective for acquisitions after May 6, 1986, buyers and sellers were required to jointly report buy-sell price allocations in their respective income tax returns using Form 8594 which was specifically designed for that purpose. See page 17.

Under Section 1060, consistent with prior law, goodwill and going-concern value were non-depreciable, non-amortizable assets.

1991 PREVIEW: "WINNERS & LOSERS" GOOD NEWS—BAD NEWS

On July 25, 1991, then Chairman Rostenkowski introduced HR3035, a bill proposing to allow the amortization of goodwill and going-concern value. This would result in major changes, because the bill would also significantly restrict the ability of purchasers to amortize certain other acquired intangible assets (such as non-compete agreements) over relatively short periods.

Chairman Rostenkowski's bill was eventually enacted as Code Section 197, effective for property acquired after August 10, 1993. It was clearly, unambiguously and unapologetically pointed out that there would be "winners and losers." The winners would be purchasers who acquired goodwill and would be able to amortize it over a 15-year period. The losers would be purchasers who acquired and paid for non-compete agreements and who would have to amortize those agreements over 15 years... instead of over the typically much shorter terms of the agreements.

The **GOOD NEWS** was that Section 197 produced certainty, simplification and a write-off for goodwill and going-concern values over 15 years; the **BAD NEWS** was that for transactions more heavily structured with non-compete agreements and other types of intangibles, the purchaser's period for amortizating payments would be significantly extended, with resulting loss of tax benefits.

"AMORTIZABLE SECTION 197 INTANGIBLES"

1. Goodwill.
2. Going-concern value.
3. Workforce in place.
4. Business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers).
5. Any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item.
6. Any customer-based intangible.
7. Any supplier-based intangible.
8. Any license, permit or other right granted by a governmental unit or an agency.
9. **ANY COVENANT NOT TO COMPETE**... or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete... entered into in connection with the direct or indirect acquisition of an interest in a trade or business.
10. Any franchise, trademark or trade name.

As can be seen from the above, many intangibles are now included in the above list of those which qualify for a 15-year amortization period.

Section 197 includes a long list of intangibles which are ***not*** eligible for 15-year amortization (see instructions for Form 8594 on page 24). The section also includes other special operating rules and rules intended to prevent after-the-fact manipulations.

GOOD MORNING NEWARK MORNING LEDGER COMPANY

Shortly before the enactment of Section 197, the Supreme Court issued its decision in *Newark Morn-*

see **SECTION 197: AMORTIZATION OF INTANGIBLES...**, page 16

(Continued from page 15)

ing Ledger Company, on April 20, 1993. In this case, the Supreme Court held that customer-based intangibles could be amortized if the taxpayer could demonstrate the value of the asset and that it did have a limited useful life. This decision moved the focus of attention from whether or not an intangible asset was goodwill to determining the accuracy and reliability of the taxpayer's valuation and useful life determinations. At that time, the IRS had hundreds of pending cases and billions of dollars tied up in similar controversies. With the Supreme Court clarification of depreciation for acquired intangibles, it seemed to make more sense to Congress to enact a provision like Section 197, than to allow an uncertain national situation to accelerate IRS/taxpayer disputes over amortization of intangibles.

NON-COMPETE AGREEMENTS UNDER SEC. 197

Unfortunately, under Section 197 a covenant not to compete was—and is—treated as an amortizable Section 197 intangible asset. As such, it must be written off over the 15-year period—beginning with the month the covenant not to compete is acquired—rather than over a 1, 3 or 5-year shorter term that otherwise would be specified in the contract and allowed as the writeoff period under prior law. Although covenants not to compete are particularly hard-hit, notwithstanding the fact that they may last only three or five years, that did not alter the general rule that **payments made under consulting agreements continued to be deductible over the term of the consulting agreements, to the extent payments were for services actually rendered and were reasonable in amount.**

Any amount that is paid or incurred under a contract not to compete arising out of a buy-sell situation includes, for purposes of this provision, "an arrangement that requires the former owner of the interest to continue to perform services (or to provide property or the use of property) that benefits the trade or business. These arrangements are considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered (or for the property or use of property actually provided) by the former owner."

The Committee Reports state "As under present law, to the extent that the amount paid or incurred under a contract not to compete...represents additional consideration for the acquisition of stock in a corporation, such amount is not to be taken into account under this provision, but, instead, is to be included as part of the acquirer's basis in the stock."

In other words, in a situation where the **stock** of the corporation is being acquired—instead of the **assets** of the business/corporation—the amount paid for a covenant not to compete will not be amortizable over 15 years under Section 197, but, instead, will be required to be capitalized as part of the cost of the stock.

Section 197(f) contains special rules which further restrict the treatment of covenants not to compete. If there is a disposition of any amortizable Section 197 intangible asset, loss will not be recognized on that disposition until all intangibles acquired have been disposed of. What happens, instead, is that there is an allocation of the amount of that loss to the remaining basis of the other intangible assets being amortized.

Another special rule provides that a covenant not to compete cannot be treated as disposed of until **all** interests in the business that was directly or indirectly acquired in connection with the creation of the covenant are disposed of or become worthless. This further restriction means that the acquiring business must continue to amortize the covenant over 15 years even though the covenant might no longer have any legal effect or value.

INTERPLAY BETWEEN SECTION 197 AND 1060

Section 1060 requires the use of the residual method to allocate the purchase price of a business among acquired tangible and intangible assets. The regulatory scheme under Section 1060—before 197 came along—created four classes of assets, of which Class IV represents goodwill and going-concern value and which received the net residual allocation after a purchase price had been allocated in order first to Class I (Cash and Demand Deposits), Class II (CD's, Government Securities and Readily Marketable Securities) and Class III (all assets other than Class I, Class II or Class III). Under Section 1060—before Section 197—a non-compete agreement was treated as Class III property; whereas under Section 197, a non-compete agreement is treated just like goodwill or going-concern value and all must be amortized over a 15-year period.

As a result of the enactment of Section 197, the provisions of Section 1060 have to be reshaped. Accordingly, the Committee Reports under Section 197 state that it is expected that the present regulations under Section 1060 will be amended to reflect the fact that an amortization deduction is now allowable with respect to intangible assets in the nature of goodwill and going-concern value. The Committee Reports further state: "It is anticipated that the residual method specified in the Regulations (under Section 1060) will be modified to treat all amortizable

see **SECTION 197: AMORTIZATION OF INTANGIBLES...**, page 18

Form **8594** (Rev. Jan. 1996) Department of the Treasury Internal Revenue Service

Asset Acquisition Statement Under Section 1060

▶ Attach to your Federal income tax return.

OMB No. 1545-1021

Attachment Sequence No. 61

Name as shown on return	Identification number as shown on return

Check the box that identifies you: ☐ Buyer ☐ Seller

Part I **General Information**—To be completed by all filers.

1 Name of other party to the transaction	Other party's identification number
Address (number, street, and room or suite no.)	
City or town, state, and ZIP code	
2 Date of sale	3 Total sales price

Part II **Assets Transferred**—To be completed by all filers of an original statement.

4 Assets	Aggregate Fair Market Value (Actual Amount for Class I)	Allocation of Sales Price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Total	$	$

5 Did the buyer 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 listed for each of asset Classes I, II, III, and IV the amounts agreed upon in your sales contract or in a separate written document? . . . . ☐ Yes ☐ No

6 In connection with the purchase of the group of assets, did the buyer 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," specify (a) the type of agreement, and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See the instructions for line 6.

Part III **Supplemental Statement**—To be completed only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration.

7 Assets	Allocation of Sales Price as Previously Reported	Increase or (Decrease)	Redetermined Allocation of Sales Price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Total	$		$

8 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

9 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

For Paperwork Reduction Act Notice, see instructions. Cat. No. 63768Z Form **8594** (Rev. 1-96)

(Continued from page 16)

Section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property covered by Section 197." Still in the same vein, the Committee Reports anticipated that the reporting terminology would be changed so that when information is provided on Form 8594, it would specify the amount of purchase price allocable to amortizable Section 197 intangibles, rather than the amount of purchase price allocable to goodwill or going-concern value.

All of this has been accomplished on the new Form 8594 which bears a January, 1996 revision date. See page 17 and the abridged instructions for Form 8594 on page 24.

SORTING IT OUT: WHAT IS ONE TO DO?

The enactment of Section 197 changed the desirability, under more typical circumstances, of having large amounts allocable to a non-compete agreement.

Reasonable consulting fees and reasonable compensation for consulting services now seem to be the "vehicle of choice" insofar as the buyer is concerned. Reasonable compensation payments under consulting arrangements continue to be deductible as incurred or paid—whereas non-compete payments no longer are.

For some dealers, this means that in order to make the deal, or to make it stick, they may need to be willing to stay on and work a little longer or be available a little longer as a consultant to the purchasers.

Since Section 197 recognizes and defines many types of amortizable intangibles, it still is prudent to identify realistically as many different intangible assets as exist and to separately assign values to them.

A first impression might be that dealership valuations now seem less important because all intangibles are grouped together with goodwill in a 15-year amortizable basket. That thought should be tempered by the consideration that as one more accurately assigns values to shorter-lived depreciable assets such as furniture, fixtures, equipment, etc., that will generate a faster write-off than will the 15-year period for intangibles.

There is also some irony in the possibility of a role reversal here...See box below.

Don't overlook the fact that, as far as the selling dealer receiving the payments is concerned, there still may be good reasons for receiving payments characterized as non-compete payments versus payments received under a consulting agreement. Payments received under a consulting agreement are not only ordinary income, but they are earned income, subject to self-employment tax. In addition, they may (1) adversely affect eligibility for Social Security benefits, (2) cause amounts received as Social Security benefits to be taxed more than they otherwise might be, and/or (3) they may trigger other code section limitations or taxes based on "earned income." Amounts received under a non-compete agreement are sometimes more aggressively treated as not being subject to self-employment taxes and as not impairing eligibility for Social Security benefits.

These discussions have reflected the perspective of changing taxation on both buyers and sellers in the very common situation where dealers seek to sell their businesses. Prior to the Tax Reform Act of 1986, the overall scheme of taxation was significantly different and the interests of buyers and sellers were presumed to result in their negotiating at arms-length. The Tax Reform Act of 1986 changed that. The IRS now refuses to recognize that the more recent increases in the marginal tax rates on ordinary income as making any significant difference...We believe the Service is incorrect on this, since the maximum effective rate on ordinary income is almost 150% of the rate on long-term capital gains.

Section 1060, enacted as part of the Tax Reform Act of 1986, created a temporary environment in which there was a definite benefit and incentive to "structure the deal" so that non-compete agreements received appropriately higher price allocations and avoided being grouped with goodwill and going-concern value as Class IV non-depreciable, non-amortizable assets. With the enactment of Section 197 in 1993, new "rules of the game" were established which now may significantly influence how the buyer and the seller should negotiate their respective sides of the deal.

ROLE REVERSAL IRONY

- Previously, buyers wanted to allocate as much of the purchase price as possible to the non-compete agreement because of the fast write-off for the buyer.
- Now a buyer's enthusiasm over that allocation is greatly lessened becuase of the mandatory 15-year recovery period.
- However, it may now be an IRS agent who argues for some greater allocation of selling price to a non-compete agreement simply because that may mean there is a correspondingly smaller amount that can be allocated to an expenditure that can be written off more rapidly!

IRS COORDINATED ISSUES PAPER (FEBRUARY, 1996) RE: COVENANTS NOT TO COMPETE

In dealership buy-sell situations, for independent and valid business reasons, the buyer may actively seek the selling dealer's agreement not to compete with the buyer after the sale date. In other instances, the "non-competition" of the selling dealer may be a "non-factor." Understanding the tax implications of non-compete agreements, as well as how the IRS looks at them, is important and considering the structuring of a deal.

BACKGROUND

The *Heritage Auto Center* case vividly illustrates how actively the IRS may challenge and reverse a buy-sell allocation for transactions before 1993. For transactions after August 10, 1993, Section 197 provides for amortization of acquired intangible assets—including goodwill and non-compete covenants—over a 15-year period. Many of the considerations discussed in the IRS' recently released Coordinated Issue Paper on Covenants Not to Compete (revision date February 19, 1996) continued to apply notwithstanding the enactment of Section 197.

In the past, when a significant differential existed between the tax rates on capital gains and the tax rates on ordinary income, the IRS was satisfied to allow that difference in tax treatment between the negotiating buyer and the seller to drive the price and the allocation of the price for various assets in the deal, including the covenant not to compete. The seller typically wanted as much allocated as possible to goodwill, and as little as possible allocated to the non-compete agreement because payments for the non-compete agreement were ordinary income whereas payments for goodwill (or for the value of the stock) received the benefit of favorable long-term capital gains rates. Conversely, the buyer preferred to allocate as much of the purchase price as possible to the covenant not to compete in anticipation of claiming ordinary deductions against income and desired to allocate as little as possible to non-depreciable goodwill or going-concern value.

The Tax Reform Act of 1986 generally eliminated the income tax treatment for long-term capital gains and eliminated what had been regarded as the competing and conflicting tax interests of the buyer and the seller with respect to the allocation of the purchase price to covenants not to compete. Recall that the buyer, Heritage Auto Center, Inc., was involved in a transaction that occurred after 1986 which was in a "time" when the tax interests of the buyer and the seller with respect to the covenant not to compete—or any other assets—were considered not to be adverse. This was because the seller really had no reason to negotiate strongly for any particular larger or smaller allocation of selling price to the covenant not to compete because there was no tax advantage in doing so. This made the seller more inclined to simply agree with whatever amount the buyer preferred to allocate to the non-compete covenant or to any other assets.

In 1990, the Omnibus Budget Reconciliation Act increased the highest marginal rates for individuals by 3% and again in 1993, the Omnibus Budget Reconciliation Act of that year increased the highest marginal tax rates for individuals from 28% and/or 31% up to 39.6% over the capital gain rate which was maxed at 28%. According to the Internal Revenue Service, these "small rate differences" do not provide a "compelling tax disincentive to buyers and sellers that would ensure that covenants not to compete reflect economic reality." In other words, even though some differential in rates was reinstated <u>to some extent</u>, the IRS position is that these rates changes are not significantly different. Many taxpayers and CPAs would not agree with this conclusion.

IRS EXAM POSITION

The general position of the Coordinated Issues Paper is that a covenant not to compete can be amortizable if the objective facts show all three of the following:

1. The covenant is genuine, i.e., it has economic significance apart from the tax consequences,
2. The parties intended to attribute some value to the covenant at the time they executed their formal buy-sell agreement, and
3. The covenant has been properly valued.

The above list is more readily recognized in the style of IRS writing when rephrased to indicate that a covenant not to compete cannot be amortized unless it satisfies all three of the above tests.

see ...**COVENANTS NOT TO COMPETE,** page 20

PROBLEMS AND TESTS

In its Coordinated Issues Paper, the Service identifies three different problems and four different tests that may be involved when non-compete disagreements arise:

1. An unrealistic value for a covenant not to compete may be specified in the agreement or it may be unrealistic for the seller to have given a covenant. Under these circumstances, the IRS subjects the covenants to the so-called "economic reality" test and observes that for transactions occurring before 1993, the allocation of price to the covenant not to compete is likely to be excessive; whereas because of the enactment of Section 197 for years after 1992, in those years, the value is more likely to be understated.
2. A lump sum purchase price for the business may have been stated in the buy-sell agreement, but no allocation of a specified portion of it is allocated to a covenant not to compete that is included in the agreement. Under these circumstances, the IRS will apply the so-called "mutual intent" test discussed below.
3. The buy-sell agreement may specifically allocate a value for the covenant not to compete, but one party unilaterally may claim a different value in its reporting position in its tax returns. Under this circumstance, the appropriate test is the "strong proof" doctrine or the even stronger "Danielson rule."

THE ECONOMIC REALITY TEST FOR "UNREALISTIC" ALLOCATIONS

Where allocations appears to be "unrealistic," the IRS looks for economic reality. Some of the factors to be considered include:

1. Did the seller have the ability to compete with the buyer?
2. What type of customer network or experience does the seller possess?
3. What is the seller's financial ability to compete?
4. What is the seller's physical ability to compete, considering age, possible health limitations, etc.
5. Are there non-contractual restrictions that might prohibit the seller from competing, for example limited market entry?

(Continued from page 19)

6. What about the seller's intention to compete, either by acquiring or by starting a new business in the same market or by seeking employment with an existing competitor?
7. Has the seller stated any intention to retire or to move from the immediate geographic area, thus posing no real competitive threat? Alternatively, might the grantor of the non-compete covenant have the ability to change plans and re-enter the market, thus signifying a stronger potential threat to the buyer?

The above tests relate to the seller's ability to compete with the buyer after the sale.

Another general area of inquiry under the economic reality test relates to whether the payments under the non-compete agreement are intended as compensation to the seller in lieu of his or her employment in a competing venture. Considerations here include

- Does the payment for the covenant realistically compensate the seller for the loss of earnings by not competing?
- If the payments are made in installments, are installment payments conditioned upon the survival of the covenantor or are remaining payments payable to the estate?

Other factors under the general economic reality test include inquiry into the formalities, the enforceability and the scope of the covenant.

MUTUAL INTENT TEST WHEN CONTRACT IS SILENT

Where no allocation of the purchase price is made to the covenant not to compete, but a covenant is included in the agreement, the mutual intent test attempts to determine whether the parties "mutually agreed that some portion of the total consideration paid for the going concern was intended for the covenant not to compete."

This mutual intent test is only applied where the agreement contains a non-compete covenant but the purchase price is stated as a lump sum for the entire transaction with no express allocation of a specific amount to the covenant not to compete. Under these circumstances, the Courts tend to look at the actual contract negotiations to determine whether the parties intended the covenant to have any value. Mutual intent is usually found where the parties bargain over the inclusion of the covenant or where it was understood that the covenant was an essential part of the agreement. Here again, the so-called "economic →

reality test" plays a part in the mutual intent inquiry insofar as the covenant not to compete must also have some independent basis in fact such that the parties might bargain for it.

Here, many variations exist, including the possibility that while the parties engaged in negotiations over the covenant not to compete, no mutual agreement was ever reached concerning the allocation of a part of the overall price to the covenant. In contrast, where the parties never even discussed the non-compete agreement, the Courts have found mutual intent to allocate nothing to it. One Court held that "for tax purposes, to ascribe value to a covenant not to compete means (to look for) the value which was the product of a realistic, bargained exchange between the parties...and not some abstract figure of market value or what *might have been* a fair and equitable cost."

STRONG PROOF DOCTRINE AND "DANIELSON RULE" WHERE PARTIES REPORT DIFFERENTLY

The strong proof doctrine and/or the "Danielson rule" are applied only in the situations where taxpayers take tax return reporting positions that are inconsistent with the specific allocation provided in the buy-sell agreement. For example, the seller may treat the entire purchase price as capital gain, despite the fact that the agreement specifically allocated some other dollar amount to the covenant not to compete. Similarly, the purchaser may claim a greater amount of amortization deductions than provided in the agreement. Typically, the Courts have refused to allow one of the parties to subsequently alter the tax consequences of the expressed contractual amount unless they can present "strong proof" that the agreement does not reflect true intentions of the parties.

Some Courts require an even stronger degree of proof before one party will be permitted to alter the allocation for tax purposes. Under the "Danielson rule," a party may contradict the unambiguous contract terms for tax purposes only by offering proof which would be admissible in an action between the parties to alter the contract or to show its unenforceability because of mistake, undue proof, fraud or duress.

From the above, it can be seen that a variety of different situations may arise requiring an evaluation of the terms—as well as a valuation—of the non-compete agreement.

VALUATION OF A NON COMPETE COVENANT

The valuation of a non-compete agreement must reflect economic reality and, as one might expect, the taxpayer bears the burden of proof. In attempting to determine the value of a non-compete agreement or covenant, several different tests may be employed:

1. Compensation-based approach...under which the seller's average compensation is calculated and projected over the life of the covenant, with a discount rate applied to adjust the gross amount to its present value. This attempts to measure the loss of earnings anticipated by the seller as a result of his forbearing from competing in the market.

2. Attempts to value the seller's non-competition with reference to the protection that it affords to the continued profitability of the business for the buyer. In other words, the attempt is made to determine the present value of the economic loss to the buyer if the seller were to re-enter the market.

3. The value of the covenant not to compete may be determined with reference to the values of other the assets acquired...and if other assets were acquired at less than their fair market value, no allocation of price would be made to the non-compete covenant.

4. Sometimes a formula approach is employed if no better basis is available and it attempts to determine the capitalization of earnings in excess of the fair rate of return on the net tangible assets.

5. There may be situations where a covenant not to compete and an employment contract are executed as part of the same overall transaction. In these instances, both agreements need to be carefully evaluated because not only might their provisions overlap, but their values might overlap also. Several articles included in the Selected Bibiography on Section 1060 (see pages 22-23) discuss valuations for non-compete agreements in some detail.

INTERPLAY WITH CODE SECTION 197

As mentioned previously, Section 197 became effective August 10, 1993 requiring 15-year straight line amortization for acquired intangible assets, including non-compete agreements along with goodwill and going-concern value.

Notwithstanding the enactment of Section 197, some of the same issues will continue to exist, especially as the buyer may now be indifferent to the amount allocated to goodwill or to a covenant not to compete because the buyer must amortize that

see **...COVENANTS NOT TO COMPETE,** page 22

SELECTED BIBLIOGRAPHY ON SECTION 1060 PRICE ALLOCATION IN ASSET ACQUISITIONS

"Purchase Price Allocations Restricted by Tax Reform Act of 1986," by Abrams and Cinnamon, *Taxation for Accountants*, January, 1987 (pages 40-44).

"Allocation of Lump-Sum Purchase Price Upon the Transfer of Business Assets After Tax Reform," by Rolf Auster, *Taxes, The Tax Magazine*, August, 1987 (pages 545-551).

"The Impact of New Section 1060 on Purchase Price Allocations," by Gary Garland, *The Tax Advisor*, November, 1987 (pages 793-799).

"Price Allocation on Acquisitions and Basis Step-Up: Tilting at Windmills?," by Roche, Myers and Zukner, *Taxes, The Tax Magazine*, December, 1987 (pages 833-845).

"Asset-Acquisition Temporary Regs. Leave Many Issues Unresolved," by Olchyk and Elliott, *Journal of Accountancy*, December, 1988 (pages 372-375).

"Purchase Price Allocations in Taxable Asset Acquisitions," by Keith Swirsky, *Taxes, The Tax Magazine*, April, 1989 (pages 252-258).

Note: See especially pages 256-257 on employment/consulting agreements.

"Avoiding Allocations to Goodwill Under the Asset-Acquisition Rules," by Wyndelts and Fowler, *The Journal of Taxation*, December, 1989 (pages 392-397).

Note: See especially page 397 re: non-compete covenants; consulting contracts.

"Traditional Tax Considerations in Sale of a Business No Longer Valid," by Green and Shapkin, *Taxation for Accountants*, July, 1990 (pages 14-20).

"Purchase Price Allocations to Covenants Not to Compete Under the Internal Revenue Code of 1986," by Joseph Jaconetta, *The Tax Lawyer*, Fall, 1990 (pages 217-241).

Note: This is an excellent and comprehensive article covering in greater detail the material in the IRS Coordinated Issues Paper released February of 1996.

"How to Value Covenants Not to Compete," by Lee Russell, *The Journal of Accountancy,* September, 1990 (pages 85-92).

Note: This article contains illustrations for valuation approaches of a non-compete agreement, including determining the probability of competition and other qualitative assessments.

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...Covenants Not To Compete

(Continued from page 21)

amount over 15 years in either event. Accordingly, where Section 197 applies, the difference in higher marginal ordinary income rates (relative to long-term capital gain rates) becomes more important to the seller...who before 1993, might have been the more allocation-indifferent party. Now, it is the buyer who would seem to be be the more indifferent party.

The Coordinated Issues Paper observes that it may be beneficial to the buyer not to have the buy-sell agreement state a specific amount as allocable to the covenant not to compete so that the buyer can allocate a greater portion of the purchase price to tangible assets having recovery periods shorter than 15 years.

For years after 1992, it may also be beneficial to the seller not to have the buy-sell agreement state an allocation of price for the covenant not to compete so that the seller does not "flag the transaction for the Service," which would require the seller to report the amount received for the covenant not to compete as ordinary income rather than as capital gain.

All of this shows that a familiarity with the risks and rules is indispensable when advising dealers on buy-sell transactions and price allocations.

SELECTED BIBLIOGRAPHY ON SECTION 1060 (Continued)

"RRA, '90 Imposes New Reporting and Consistency Requirements for Asset Acquisitions," by Fowler, Zolintakis and Deats, *The Journal of Accountancy*, April, 1991 (pages 204-210).

"Allocating Purchase Price to Assets Regains Importance," by Smith, Hennessee and Hutton, *Taxation for Accountants*, May, 1991 (pages 290-294).

"Report on Proposed Legislation of Amortization of Intangibles (H.R. 3035)," by the New York State Bar Association Tax Section, reprinted in *Tax Notes*, November 25, 1991 (pages 943-966).

"Maximizing Amortization Deductions for Non-Compete Covenants," by Robert Reilly, *The Practical Accountant*, December, 1991 (pages 40-47).

Note: This article also contains sample valuations using a discounted net cash flow analysis approach.

"Asset Sales Come Under Tighter Scrutiny by IRS," by Howard Strum, *Taxation for Accountants*, March, 1992 (pages 159-164).

"Determination and Valuation of Goodwill Using a Proven, Acceptable Method to Withstand IRS Challenge," by Fenton, Van Alst, and Isaacs, *The Tax Advisor*, September, 1992 (pages 602-612).

"Covenants Not to Compete Are Still Useful After RRA '93," by Michael Schlesinger, *Taxation for Accountants*, October, 1993 (pages 204-209).

SELECTED BIBLIOGRAPHY ON SECTION 197 COVENANTS NOT TO COMPETE, GOODWILL AND CERTAIN OTHER INTANGIBLES

"The Controversy Surrounding Customer-Based Intangibles," by Burckel, Daughtrey and Carter, *The CPA Journal*, May, 1992 (pages 44-50).

"Supreme Court's Decision on Amortizing Intangibles Removes One Barrier," by Levy, MacNeil and Young, *The Journal of Taxation*, July, 1993 (pages 4-10).

"Supreme Court Clarifies Depreciation of Acquired Intangibles," by Nellen and Massey, *Taxation for Accountants*, August, 1993 (pages 68-75).

"Structuring Taxable Acquisitions of Intangibles Under Section 197," by George Brode, Jr., *Tax Notes*, August 16, 1993 (pages 1011-1024).

"The Amortization of Purchased Intangible Assets," by Wertlieb, Scarabello and Curran, *The Tax Adviser*, September, 1993 (pages 583-592).

"The Amortization of Intangibles: Before and After Section 197," by James A. Doering, *Taxes*, October, 1993 (pages 621-635).

"RRA '93 Simplifies Rules on Acquired Intangible Assets," by Annette Nellen, *Taxation for Accountants*, November, 1993 (pages 268-276).

"15-Year Amortization of Purchased Intangible Assets—Some Winners, Some Losers," by Glenn F. Mackles, *The Journal of Taxation*, December, 1993 (pages 332-336).

"Evaluating the Service's Settlement Initiative for Intangible Assets," by Jones and Rood, *The Journal of Taxation*, April, 1994 (pages 196-202).

"15-Year Amortization May Hold Opportunities for Realty-Related Intangibles," by McBurney and Middleton, *The Journal of Taxation*, August, 1994 (pages 94-99).

"A Pragmatic Approach to Amortization of Intangibles," by Dilley and Young, *The CPA Journal*, December, 1994 (pages 46-56).

Form **8594**
(Rev. Jan. 1996)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement Under Section 1060

General Instructions

A Change To Note

The Revenue Reconciliation Act of 1993 changed the definition of Class IV assets from goodwill and going concern value to amortizable section 197 intangibles. See "Class IV assets" under Definitions below.

Purpose of Form

Both the seller and buyer of a group of assets that makes up a trade or business must use Form 8594 to report such a sale if goodwill or going concern value attaches, or could attach, to such assets and if the buyer's basis in the assets is determined only by the amount paid for the assets ("applicable asset acquisition," defined below). Form 8594 must also be filed if the buyer or seller is amending an original or a previously filed supplemental Form 8594 because of an increase or decrease in the buyer's cost of the assets or the amount realized by the seller.

Who Must File

Subject to the exceptions noted below, both the buyer and the seller of the assets must prepare and attach Form 8594 to their Federal income tax returns (Forms 1040, 1041, 1065, 1120, 1120S, etc.).

Exceptions. You are not required to file Form 8594 if any of the following apply:

1. The acquisition is not an applicable asset acquisition (defined below).

2. A group of assets that makes up a trade or business is exchanged for like-kind property in a transaction to which section 1031 applies.

3. A partnership interest is transferred. See Regulations section 1.755-2T for special reporting requirements.

When To File

Generally, attach Form 8594 to your Federal income tax return for the year in which the sale date occurred. If the amount allocated to any asset is increased or decreased after Form 8594 is filed, the seller and/or buyer (whoever is affected) must complete Part I and the supplemental statement in Part III of a new Form 8594 and attach the form to the Federal tax return for the year in which the increase or decrease is taken into account.

Definitions

"Applicable asset acquisition" means a transfer of a group of assets that makes up a trade or business in which the buyer's basis in such assets is determined wholly by the amount paid for the assets. An applicable asset acquisition includes both a direct and indirect transfer of a group of assets, such as a sale of a business.

"Class I assets" are cash, demand deposits, and similar accounts in banks, savings and loan associations and other depository institutions, and other similar items that may be designated in the Internal Revenue Bulletin.

"Class II assets" are certificates of deposit, U.S. Government securities, readily marketable stock or securities, foreign currency, and other items that may be designated in the Internal Revenue Bulletin.

"Class III assets" are all tangible and intangible assets that are not Class I, II, or IV assets. Amortizable section 197 intangibles are Class IV assets. Examples of Class III assets are furniture and fixtures, land, buildings, equipment, and accounts receivable.

"Class IV assets" are amortizable section 197 intangibles, which generally include:

- Goodwill,
- Going concern value,
- Workforce in place,
- Business books and records, operating systems, or any other information base,
- Any patent, copyright, formula, process, design, pattern, know-how, format, or similar item,
- Any customer-based intangible,
- Any supplier-based intangible,
- Any license, permit, or other right granted by a governmental unit,
- Any covenant not to compete entered into in connection with the acquisition of an interest in a trade or a business, and
- Any franchise (other than a sports franchise), trademark, or trade name.

However, the term "section 197 intangible" **does not** include any of the following:

- An interest in a corporation, partnership, trust, or estate,
- Interests under certain financial contracts,
- Interests in land,
- Certain computer software,
- Certain separately acquired interests in films, sound recordings, video tapes, books, or other similar property,
- Certain separately acquired rights to receive tangible property or services,
- Certain separately acquired interests in patents or copyrights,
- Interests under leases of tangible property,

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