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Federal Tax Reform and the Future of §197

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THREE DECADES OF TAX REFORM DISCUSSIONS

For more than the past decade, tax reform has been a significant discussion item for Congress and the current and past two administrations. At the start of the 112th Congress, Chairman of the House Ways and Means Committee, Dave Camp (R-MI), kicked off the ''first in a series of hearings on tax reform.''[1] More than 100 hearings have been held since that time. President Bush's Advisory Panel on Federal Tax Reform issued an extensive report with proposals in 2005.[2] In addition, under President Bush, the Treasury Department studied and issued a report in 2007 on improving the competitiveness of the tax system and moving it into the 21st century.[3]

President Obama's Economic Recovery Advisory Board issued a tax reform report in 2010,[4] and his National Commission on Fiscal Responsibility and Reform (aka Simpson-Bowles Commission) issued a report in 2010.[5] President Trump offered several tax reform ideas during his campaign and released a brief framework for reform in April 2017.[6]

There are even more tax reform ideas and analysis if we look at the time between enactment of the Tax Reform Act of 1986 (TRA86), the last time comprehensive tax reform occurred, and President Bush's Advisory Panel on Federal Tax Reform. In addition to numerous congressional hearings and proposals during the 1990s, in 1996, the National Commission on Economic Growth and Tax Reform held hearings, developed working principles for reform and released a 96-page report aimed at moving the tax system into the 21st century.[7]

In addition to hearing testimony, proposals, and studies, numerous reports have been issued by the Joint Committee on Taxation, Congressional Budget Office, Congressional Research Service, and many other government agencies and interested organizations.

Proponents for tax reform cite various reasons or principles that commonly include the following:[8]

- Simplicity
- Fairness
- Certainty

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[1] House Ways and Means Committee, First in a Series of Hearings on Fundamental Tax Reform (Jan. 20, 2011) (https://waysandmeans.house.gov/event/first-in-a-series-of-hearings-on-fundamental-tax-reform/).

[2] President's Advisory Panel on Federal Tax Reform (Nov. 2005) (http://govinfo.library.unt.edu/taxreformpanel/).

[3] Office of Tax Policy, U.S. Dept. of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (Dec. 20, 2007) (https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Improve-Competitiveness-2007.pdf).

[4] The President's Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation* (Aug. 2010) (https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Tax-Reform-Options-2010.pdf).

[5] The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth* (Dec. 2010) (http://momentoftruthproject.org/sites/default/files/TheMomentofTruth12_1_2010.pdf).

[6] The White House, 2017 Tax Reform for Economic Growth and American Jobs (Apr. 2017).

[7] National Commission on Economic Growth and Tax Reform, Unleashing America's Potential — A pro-growth, pro-family tax system for the 21st century, Jan. 1996; included in the record of a Senate Finance Committee hearing on the report, S. Hrg. 104-880 (Jan. 31, 1996) (https://www.finance.senate.gov/imo/media/doc/Hrg104-880.pdf).

[8] See, for example, House Ways and Means Committee Chairman Brady's principles (https://kevinbrady.house.gov/legislation/tax-reform.htm), Senate Finance Committee Chairman Hatch (https://www.finance.senate.gov/ranking-members-news/hatch-outlines-seven-principles-for-comprehensive-tax-reform), and a joint statement of July 27, 2017 by leaders of the tax committees, Treasury, and White House (https://www.treasury.gov/press-center/press-releases/Pages/sm0134.aspx).

- Economic growth
- Competitiveness

These principles, cited often and by many, seem to have no opposition.

Tax reform discussions have included moving from our income tax to some type of consumption tax. Most often, the reform proposals and discussions focus on changes within our current income tax system. In recent years, reform discussions and proposals have focused on lowering income tax rates and moving to a territorial tax system, in a revenue neutral manner. Thus, as part of lowering tax rates, the income tax base is broadened, such as by removing deductions and credits and/or lengthening the lives of depreciable assets.

The discussions and proposals have also included moving to or adding a consumption tax, such as a VAT or national retail sales tax. Other forms of consumption tax, based on the formula: *consumption = income less savings*, have also been proposed.

Most proposal, for lower rates, via base broadening or shifts from an income tax to a consumption tax, change the tax treatment of intangibles. This article examines some of the major proposals of recent years and how they would change the tax treatment of owning, using, and disposing of intangible assets, with a focus on the effect to §197, *Amortization of goodwill and certain other intangibles*.

SECTION 197

Section 197 was enacted in 1993[9] to allow for amortization of goodwill and going concern value. For simplification and anti-abuse purposes, a 15-year life was provided for most acquired intangibles including customer lists, workforce in place, and most intangibles acquired along with assets constituting a trade or business.[10]

Intangible Assets — 1986 Versus Today

Talk of intangible assets in the 1980s centered primarily on intellectual property, such as patents and copyrights. While software had existed for some time, there was uncertainty in the courts as to whether it was tangible, intangible, or services.[11] Desktop computers and ''off-the-shelf'' software were relatively new and not widely in use. The internet as we know it today, the ''cloud,'' and the use of digital assets in our personal lives and as business models did not exist.

A focus on goodwill though, was part of the TRA86 via enactment of §1060, *Special allocation rules for certain asset acquisitions*. This rule called for use of the residual method to value goodwill, which remained non-amortizable with TRA86.

While language was included in §197 to perhaps contemplate new types of intangibles, it is not broad enough to cover all types of intangible assets. Soon after 1993, the range of intangibles started to expand primarily due to changes to the internet to readily enable access for both personal and commercial purposes. For example, domain names (or URLs (Uniform Resource Locator)) are commonly created and acquired assets today that don't specifically fall under §197, potentially making them unamortizable. While §197(d)(1)(C)(vi) covers ''any other similar item'' it only covers items similar to workforce in place, business books and records, intellectual property, customer-based intangibles, and supplier-based intangibles. Congress did not include a subsection (G) in §197(d)(1) in defining ''Section 197 intangible'' to include any intangible asset unless excepted in §197 or its regulations.

Today, in addition to domain names, some social media assets, such as a Twitter identification or a blog site, don't generally fit within the statutory provisions of §197, although they fit within the legislature's purpose in enacting §197.[12] That purpose was to eliminate controversy for acquired intangible assets by providing a single method and life for them.[13]

Much has changed since TRA86, most notably, the importance, nature, variety, and prevalence of intangible assets. A 2006 report of the Federal Reserve Board noted that investment in intangibles in the United States exceeds investment in tangible assets.[14] Thus, we should expect tax reform discussions today, compared to TRA86, to include greater focus on key business and productivity assets — intangibles.

TAX REFORM FOCUSED ON BROADENING THE INCOME TAX BASE

Tax reform efforts today are primarily focused on lowering income tax rates in a revenue neutral manner. The approach to achieve lower rates without increasing deficits is to broaden the base and consider expected economic growth. Base broadening includes eliminating and reducing special deductions, exclusions, and credits. It also often means timing adjustments to stretch out deductions, such as for deprecia-

[9] Pub. L. No. 103-66, §13261.

[10] For details on §197, see Nellen, 533 T.M., *Amortization of Intangibles*. All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[11] See, for example, *Comshare, Inc. v. United States*, 27 F.3d 1142 (6th Cir. 1994), reversing the lower court to find that software was eligible for the investment tax credit (repealed by the TRA86) because it was on tangible media.

[12] *See* Nellen, 533 T.M., *Amortization of Intangibles*, III.C.

[13] *See id.*, III.A.

[14] National Research Council, Intangible Assets: Measuring and Enhancing Their Contribution to Corporate Value and Economic Growth — A Workshop Summary, 2009, at 1 (https://www.nap.edu/catalog/12745/intangible-assets-measuring-and-enhancing-their-contribution-to-corporate-value).

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tion or R&D. Following are some examples of base-broadening, income tax reform proposals that would modify §197.

- H.R. 1 (113th Congress), Tax Reform Act of 2014: This is Congressman Camp's proposal. It was scored and found revenue neutral. This proposal would lower the corporate rate to a flat 25% and lower the top individual rate to 35%. It would extend the life of §197 intangibles from 15 years to 20 years. This change was estimated to generate $13 billion over 10 years.[15] H.R. 1 includes additional changes to intangible assets or benefits. For example, large taxpayers would have to capitalize a portion of their advertising expenditures and amortize that amount over 10 years. Also, the deduction for research expenditures under §174 would change from expensing when incurred to capitalizing and amortizing over five years.
- H.R. 3970 (110th Congress), the Tax Reduction and Reform Act of 2007: This bill proposed to repeal the individual AMT, lower the top corporate tax rate and increase the §197 amortization period from 15 years to 20 years, among other changes. No change in depreciable life of tangible assets was proposed.
- President Bush's Advisory Panel on Federal Tax Reform (2005): The extensive report released by the panel included two proposals: (1) the Simplified Income Tax Plan, and (2) the Growth and Investment Tax Plan (a consumption tax). The Simplified Income Tax would allow small businesses to expense all acquired assets — both tangible and intangible (other than land and buildings).[16]

TAX REFORM FOCUSED ON ADDING OR MOVING TO A CONSUMPTION TAX

Over the past several decades, there have been proposals for a value-added tax (VAT), national retail sales tax, flat tax (a form of subtraction method VAT), and formula approaches (consumption = income less savings). Some of these proposals are intended to replace the income tax while others would be an add-on to the income tax. Generally, under a consumption tax, savings are exempt. For a formula type consumption tax to exempt savings associated with business investments, assets are expensed upon acquisition (and sales proceeds are included in the tax base). Thus, there would be no need for depreciation and amortization rules (other than perhaps for existing depreciable asset at enactment date). In addition, interest income and expense are not taxed. A few key proposals are summarized below with an explanation of what happens to intangible assets.

- House Republican Tax Reform Blueprint (June 2016): This plan calls for moving business taxation to a ''cash-flow tax approach'' that ''reflects a consumption-based tax.'' The rationale for this approach is to allow a border adjustable tax where exports are exempt (by excluding them from revenues) and imports are taxed (by denying a deduction for them). As a consumption tax, business assets — both tangible and intangible (other than land), are immediately expensed. Interest expense would only be deductible to the extent of interest income with the balance carried forward subject to the same limit annually.[17]
- President Bush's Advisory Panel's Growth and Investment Tax Plan: This consumption tax proposal would allow all businesses to expense acquired assets and interest expense was not deductible.[18]
- H.R. 25 (115th Congress), the Fair Tax Act of 2017: This proposal calls for replacing the income tax with a 23% sales tax imposed on a tax-inclusive basis. The sales tax base would exclude intangible assets and used goods. The sales tax would not apply to property or services purchased for a business purpose. Thus, the distinction between intangibles and tangible assets and services, as well as how they are used, would be more significant than under the income tax. H.R. 25 has been introduced every session of Congress going back as far as the 108th Congress (2003–004).
- H.R. 1040 (115th Congress), the Flat Tax Act: This bill proposes to allow taxpayers to irrevocably elect to be subject to the flat tax rather than the income tax. The flat tax would be imposed at a rate of 17% once phased in. Businesses deduct the cost of assets used in the business against its

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[15] Joint Committee on Taxation, *Technical Explanation, Estimated Revenue Effects, Distribution Analysis, and Macroeconomic Analysis of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code*, JCS-1-14 (Nov. 18, 2014), page 644. *See also* House Ways and Means Committee, Camp Formally Introduces the Tax Reform Act of 2014 (Dec. 11, 2014) (https://waysandmeans.house.gov/camp-formally-introduces-the-tax-reform-act-of-2014/).

[16] Report of the President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System (Nov. 2005), p. 95 (http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html).

[17] House Republicans, ''A Better Way,'' Tax plan (June 24, 2016), pp. 25 to 28 (https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf).

[18] Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005).

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gross receipts. When business assets are sold, the sales price is part of taxable receipts. H.R. 1040 has been introduced each session of Congress dating back to the 105th Congress (1997–1998).[19]

OTHER TAX REFORM PROPOSALS

Other reform proposals include ones that do not make comprehensive changes, but still call for significant changes relative to existing law. For example, S. 1144 (115th Congress), Investment in New Ventures and Economic Success Today (INVEST) Act of 2017, would accelerate depreciation and broaden availability of the cash method of accounting, among other changes. It would increase the §179 expensing amount from $500,000 to $2 million. S. 1144 would shorten the life of §197 intangibles from 15 years to 10 years.

President Obama's revenue proposals included repeal of the anti-churning rule of §197(f)(9). This was proposed as a simplification measure due to the complexity of the rule. In addition, his proposal noted that given that the provision was enacted over 20 years ago, most of today's intangibles are not even subject to the rule.[20]

S. 3974 (109th Congress) would allow expensing of up to $5 million of §197 intangibles if acquired from an eligible small business (annual average gross receipts in the prior 3-year period of $5 million or less). The purpose was to better reflect the economic life of acquired intangibles and ''to encourage growth in industries for which intangible assets are an important source of revenue.''[21]

Another tax reform activity affecting intangible assets has taken place at the international level. In 2013, at the request of G8 leaders, the OECD began a project on BEPS — Base Erosion and Profit Shifting.[22] The impetus for the study was changes in how businesses generate and source income in the digital economy. For example, some companies shift tax consequences to jurisdictions where they have little economic activity. The project identified 15 ''action items'' for further study and recommendation. Given that the digital economy relies heavily on intangible assets, intangibles were addressed in several ways throughout the study. For example, Action Item Numbers 8 through 10 address transfer pricing and value creation with an emphasis on the treatment of intangible assets including goodwill. A concern addressed is the ''misallocation of the profits generated by valuable intangibles'' and the effect on base erosion and profit shifting.[23] The results of this study and its recommendations may affect U.S. tax reform efforts and IRS guidance.

MODERNIZATION AND REFORM OF §197

With intangibles becoming even more significant to all businesses since 1993 when §197 was enacted, it is surprising that §197 doesn't garner more attention in tax reform efforts. Proposals of recent years have included both lengthening and shortening the lives of acquired intangible assets. For economic growth and international competitiveness reasons, reducing the life of acquired intangibles makes more sense.

Simplification is another commonly cited reason for tax reform. While some proposals would allow for expensing of most business assets including acquired intangibles, others have focused on increasing the §179 expensing limit for tangible assets. For simplification and economic growth reasons, why isn't the expensing rule of §179 expanded to include acquired intangibles? Today, businesses of all sizes acquire intangibles for operations including patents, customer lists, domain names, and social media assets.

TAX REFORM ISSUES

Tax reform of business assets will raise several related issues that must also be addressed in tax reform. This includes complex matters that likely slow down reaching the finish line for tax reform, along with issues of finding base broadeners to allow for lower tax rates in a revenue neutral manner. Issues related to tax reform that changes the treatment of acquired business assets include the following topics.

- If tax reform results in expensing of business assets, should interest expense deductions be reduced? Arguably, yes. As noted in the House Republican blueprint, allowing expensing and an interest deduction ''would be distortive as it would result in a tax subsidy for debt-financed investment.''[24] However, for businesses that have been enjoying expensing under §179 with no limitation on the deductibility of business interest, any new interest expense limitation will be an adverse change. What changes, if any, might be needed to the cancellation of indebtedness income exclusion

[19] The flat tax is modeled after the flat tax introduced in 1981 by Robert Hall and Alvin Rabushka (http://www.hoover.org/research/flat-tax).

[20] Dept. of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals* (Feb. 2016), p. 247 (https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf).

[21] Introduction to S. 3974 (109th Cong.).

[22] The Organization for Economic Cooperation and Development (OECD), *OECD Reports to G8 on Global System of Automatic Exchange of Tax Information* (June 18, 2013) (http://www.oecd.org/newsroom/oecd-reports-to-g8-on-global-system-of-automatic-exchange-of-tax-information.htm). See information about the project and the 15 action items and status at (http://www.oecd.org/tax/beps.htm).

[23] OECD/G20 Base Erosion and Profit Shifting Project, *Executive Summaries*, 2015 Final Reports, at 27 (Oct. 2015) (http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf).

[24] House Republicans, ''A Better Way,'' Tax plan (June 24, 2016), page 26 (https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf).

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of §108, if assets are expensed and interest is not deductible?

- If amortization rules under §197 change, what transition rules will be created for unamortized §197 intangibles at date of enactment? For example, if expensing is allowed for newly acquired intangibles, will assets at enactment date continue to be amortized under §197? The answer likely is yes due to the higher cost of expensing, although some complexity remains with having two sets of rules for acquired intangibles. If amortization rules become more favorable with tax reform, will anti-churning rules be added to ensure taxpayers cannot get the more favorable treatment for existing assets they own? Likely yes, despite the added complexity.

- If §197 remains, even if only for acquired intangibles that exist at enactment date, will it be modernized to clearly address intangibles, such as domain names, that rose in prominence after §197 was enacted in 1993?

TAX REFORM RECOMMENDATION FOR §197

A few suggestions for tax reform of acquired intangible assets:

- If 100% expensing of tangible assets is part of tax reform, it should also extend to acquired intangible assets because both categories of assets are important to business growth.

- If 100% expensing of assets is not part of tax reform, §179 on expensing of tangible assets should be broadened to also include acquired intangible assets to make the tax system simpler and recognize that today, businesses of all sizes need both tangible and intangible assets to operate.

- If expensing of assets is not part of tax reform, the following changes to §197 should be considered:
  — The lives of acquired intangible assets should be shortened to better reflect the realities of today's fast-changing business environment.
  — To be sure §197 covers the broad range of acquired intangibles that exist today and that are yet to be created, subsection (G) should be added to §197(d)(1): ''any intangible asset unless excepted in §197 or its regulations.''
  — Repeal the anti-churning provision at §197(f)(9) for the reasons noted earlier in the discussion of President Obama's revenue proposals.

LOOKING FORWARD

Will three decades of tax reform discussions, frameworks, proposals, and analysis lead to tax reform in the 115th Congress? It appears likely given that over this period of time, bipartisan support has existed for a simpler system that better promotes economic growth. Also, the need for a tax system that is more internationally competitive becomes more pressing each year and is likely the driver that can lead to tax reform.

Key players in today's tax reform debate (chairs of the tax committees, the Treasury Secretary, and the White House) issued a ''joint statement on tax reform'' on July 27 that noted:[25]

> ''Given our shared sense of purpose, the time has arrived for the two tax-writing committees to develop and draft legislation that will result in the first comprehensive tax reform in a generation. It will be the responsibility of the members of those committees to produce legislation that achieves the goals shared broadly within Congress, the Administration, and by citizens who have been burdened for too long by an outdated tax system.''

The joint statement includes an expectation for a proposal to work its way through the tax committees this fall. The statement drafters also note that the proposal will lower tax rates and allow ''unprecedented capital expensing.'' Ideally, drafters will consider reform for both tangible and intangible assets in that plan, with consideration given to issues and needs for intangible assets noted in this article.

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[25] Treasury Dept., ''Joint Statement on Tax Reform'' (July 27, 2017) (https://www.treasury.gov/press-center/press-releases/Pages/sm0134.aspx).

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