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**MAKING IRC SECTION 197 MORE RELEVANT AND SIMPLER
FOR TODAY'S DIGITAL ECONOMY**

This proposal was prepared by Annette Nellen.¹ The author thanks reviewers Mark Hoose and Robert Kovacev for their helpful comments.²

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² Although the author or reviewers on this project might have clients or employers affected by the rules addressed in this paper, no such person has been specifically engaged by a client or employer to participate on this proposal.

EXECUTIVE SUMMARY

Section 197 was enacted in 1993 to address a significant issue of whether certain intangibles such as workforce in place and customer lists were amortizable and if yes, how to determine the amortizable life. The IRS and some courts viewed these types of intangibles as too similar to goodwill which at the time was not amortizable for tax purposes. Section 197 generally allows acquired intangibles, including goodwill, to be amortized over 15 years using the straight-line method. While the list of amortizable Section 197 intangibles is broad, it does not address all types of intangibles acquired for use in a business, particularly those that only came into existence after 1993 such as domain names for websites (URLs), various social media assets such as Twitter usernames or handles, and some metaverse assets.

This proposal suggests changes to Section 197 to bring clarity and certainty to the treatment of modern types of acquired intangibles for use in a business. This treatment is in line with why Section 197 was enacted and will eliminate uncertainty on the treatment of commonly acquired intangible assets used by a business. This clarification will also improve equity and efficiency in the treatment of all types of assets used in a business.

This paper also recommends that modernization of Section 197 include repeal of what should be considered a “deadwood” provision today, specifically, repeal of the anti-churning rule at Section 197(f)(9).

This paper also proposes that when favorable tax treatment is provided to tangible business assets consideration should also be given to expanding the covered assets to include certain acquired intangibles that play an operational role similar to equipment and other tangible personal property.

Finally, given the expansion of the types of intangible assets used by businesses today relative to 1993, and the continuing innovation and changes in the digital world, this paper proposes a study of today’s intangibles, similar to what the GAO released in 1991 that informed the design and enactment of Section 197 in 1993. A study would allow for review of categorization and description of all intangible assets used in a business today, appropriate amortization lives, treatment of self-created intangibles for use in the business and acquisition of any intangible that is not part of the acquisition of a trade or business (separately acquired) and be informed by economic analysis and public comment.

DISCUSSION

I. WHY SECTION 197 SHOULD BE UPDATED AND MODERNIZED

Intangible assets are significant business assets that continue to expand as to the nature of such assets and to grow in importance in today's digital age. To treat businesses more similarly rather than favor those with mostly tangible assets, to provide certainty, and to address types of intangible assets that did not exist in 1993, Section 197 needs to be updated and modernized.

IRC Section 197 was enacted in 1993³ to address a significant issue of whether certain intangibles such as workforce in place and customer lists were amortizable and if yes, how to determine the amortizable life. The IRS and some courts viewed these types of intangibles as too similar to goodwill which at the time was not amortizable for tax purposes. Prior to enactment of Section 197, a study by the GAO on 175 types of intangibles identified within nine industry groups suggested the need for guidelines for amortization of these assets to prevent ongoing disputes between taxpayers and the IRS and to "provide uniform treatment for all taxpayers."⁴

Section 197 generally allows acquired intangibles for use in a trade or business, including goodwill, to be amortized over 15 years using the straight-line method. Congress intended for Section 197 to provide "a single method and period for recovering the cost of most acquired intangible assets and by treating acquired goodwill and going concern value as amortizable intangible assets."⁵

While the list of amortizable Section 197 intangibles is broad, it is a list assembled in the early 1990s. The enactment of Section 197 predates the start of eBay, Amazon.com, Netscape, Google, and Decentraland. Enactment prior to widespread use of email and the Internet and before e-commerce and social media became vital elements of everyday business activities, means that many critical types of intangibles that a business may acquire and use are not specifically noted in Section 197.

Commonly acquired intangibles today that may not readily fall into a Section 197 asset category created in 1993 include domain names for websites (URLs), various social media assets such as Twitter usernames or handles, and various digital assets such as acquired virtual land and avatars used in a digital marketplace like the metaverse. While some of these assets may be like the list of amortizable assets specified at Section 197(c) they do not exactly fit into any of the specified categories. But given legislative intent in enacting Section 197, these new types of assets, particularly where they do not have a readily determinable life, likely would have been included in Section 197 if they had existed in 1993. Broadening of the language defining amortizable Section 197 intangible should also consider new types of intangibles that will continue to come into existence.

Section 197 should be updated to ensure that modern and future types of acquired intangibles are Section 197 intangibles rather than assets with an uncertain life or unamortizable. Section 197 should also be modernized to ensure that the list of self-created assets and separately

³ Revenue Reconciliation Act of 1993, P.L. 103-66, §13261.

⁴ General Accounting Office, *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, GAO/GGD-91-88, August 1991, page 3; <https://www.gao.gov/assets/ggd-91-88.pdf>.

⁵ House Committee Report to P.L. 103-66, included in "reasons for change."

acquired intangibles (not acquired as part of a trade or business) that are not Section 197 intangibles is appropriate to the purpose of Sections 197 and 162. This update is in line with why Section 197 was enacted, will eliminate uncertainty on the treatment of commonly acquired intangible assets today and in the future, and ensure consistent treatment of these assets by businesses.

Modernization of Section 197 should include repeal of what can be considered a “deadwood” provision today—the anti-churning rule at Section 197(f)(9).

For economic stimulus and development and equity among types of businesses, when favorable tax treatment is provided to tangible business assets consideration should also be given to expanding the covered assets to include certain acquired intangibles that play an operational role similar to equipment and other tangible assets. These favorable depreciation rules are often designed to encourage the purchase of the favored assets and that position also applies to certain intangible assets. These taxpayer favorable provisions include expensing under Section 179, bonus depreciation, and short lives.⁶

Finally, given the expansion of the types of intangible assets used by businesses today relative to 1993, and the continuing innovation and change on how businesses operate in the digital world and the types of assets used, it would be informative to study today’s intangibles, similar to what the GAO did in 1991 leading up to the enactment of Section 197.⁷ This would allow for review of categorization and description of intangible business assets, appropriate amortization lives, treatment of self-created intangibles for use in the business and separate acquisition of intangible assets (not acquired as part of the acquisition of a trade or business). A study allows for appropriate legal and economic analysis with input through public comment.

II. PROPOSED MODIFICATION TO THE DESCRIPTION OF “SECTION 197 INTANGIBLE”

IRC Section 197(d)(1), generally defines “section 197 intangible” as:

- (A) goodwill,
- (B) going concern value,
- (C) any of the following intangible items:
 - (i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,
 - (ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),
 - (iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

⁶ Most of the proposals in this paper were previously presented by the author in “Federal Tax Reform and the Future of §197,” BloombergBNA, Tax Management Memorandum, Vol. 58, August 21, 2017, page 351; https://www.sjsu.edu/people/annette.nellen/FedTaxRef_197_TMM_8-21-17.pdf. The universe of intangible assets used by businesses has grown even since 2017.

⁷ General Accounting Office, *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, GAO/GGD-91-88, August 1991, page 3; <https://www.gao.gov/assets/ggd-91-88.pdf>.

- (iv) any customer-based intangible,
 - (v) any supplier-based intangible, and
 - (vi) *any other similar item*, [emphasis added]
- (D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,
- (E) 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 an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and
- (F) any franchise, trademark, or trade name.

Treas. Reg. 1.167(a)-3(b), Safe harbor amortization for certain intangible assets, provides that certain intangible assets may be treated as having a useful life of 15 years. However, exceptions to this 15-year amortization period include most intangibles acquired from another person (unless it is an amortizable “section 197 intangible”), or where the asset has a useful life that can be estimated with reasonable accuracy.

Analysis: While the term “any other similar item” is included in the definition of section 197 intangible (see above highlight), it is limited to the items that fall under Section 197(d)(1)(C), rather than to the entire list of intangibles at Section 197(d)(1). It is not clear that all modern intangibles such as social media assets and domain names are like the items listed at Section 197(d)(1)(C); likely most new types of intangibles do not fit into the above categories. Section 197 should not leave taxpayers with uncertainty as to whether a domain name or Twitter handle, for example, are a customer-based intangible or similar item.

Treas. Reg. 1.167(a)-3(b) (above) does not eliminate the need to modernize the list of Section 197 intangibles because it also leaves uncertainty as to the treatment of a domain name, social media intangibles and similar intangibles acquired as part of a trade or business for use in a business.

It would provide greater certainty and simplicity for Section 197(d) to be modified to list a domain name and social media assets such as by adding the following to the end of paragraph (d)(1) the following new categories:

- (G) domain name or similar asset
- (H) social media and similar assets

Also needed to modernize Section 197 is to determine which missing modern intangibles should be excepted under the general exceptions for self-created intangibles and/or separately acquired intangibles. Sections 197(c) and 197(e) provide several exclusions, notably, the following:

- Self-created Section 197 intangibles other than items described in (D), (E) and (F) at Section 197(d) (see above) are not 15-year intangible assets. Thus, a self-created trademark is a 15-year intangible asset, but the costs to create a customer list or goodwill is not a Section 197 intangible (generally, such costs are deducted when incurred; that is, the customer list is created from daily business operations).

- Computer software that is readily available for purchase by the general public, is subject to a nonexclusive license and has not been substantially modified, such as purchasing a license to use Microsoft Word. Generally, acquired “off-the-shelf” software is treated as an intangible amortized over 36 months (Section 167(f)).
- Certain interests or rights acquired separately (not as part of the assets constituting a trade or business). This exception at Section 197(e)(4) applies to the following assets:
 - Any interest in a film, sound recording, video tape, book, or similar property.
 - Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof.
 - Any interest in a patent or copyright.
 - To the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right—(i) has a fixed duration of less than 15 years, or (ii) is fixed as to amount and, without regard to this section, would be recoverable under a method similar to the unit-of-production method.
- Intangibles acquired in an anti-churning transaction per Section 197(f)(9).⁸

Self-created domain names, social media and metaverse intangibles and similar digital assets should be excluded for the same reasons why self-created customer-based intangibles and goodwill are excluded (they are generated from daily business activities). Whether a separately acquired domain name or other digital assets not specifically listed in Section 197 should be excluded from being a 15-year amortizable intangible asset warrants further study, along with review of the current list at Section 197(e)(4).

Further study and public comment should prove valuable in best defining the categories to be added to Section 197 as well as indicating which should be excluded from Section 197 if self-created and/or separately acquired.

III. REPEAL THE ANTI-CHURNING RULE AT IRC SECTION 197(f)(9)

Section 197(f)(9) provides an anti-churning rule that excludes from the term “amortizable section 197 intangible” certain intangibles (i) held or used during the “transition period” defined as any period on or after July 25, 1991 and on or before enactment date (August 10, 1993) by the taxpayer or a related person, or (ii) acquired from someone who held the intangible during the transition period and as part of the transaction the user of the intangible does not change, or (iii) where the right to use the intangible is granted to a person (or someone related to that person) who held or used the intangible during the transition period.

Anti-churning rules serve an important purpose when a significant, favorable depreciation or amortization rule is added to the law. Such a rule prevents a taxpayer from

⁸ See separate discussion in this paper about repealing Section 197(f)(9).

engaging in transactions to enable existing ownership of assets to be transferred in some way to become subject to the new rule.

The Section 197 anti-churning rule is quite complex for various reasons including concern about converting pre-Section 197 goodwill into an amortizable asset and issues regarding various transactions involving partnerships. An indication of the complexity is the length and intricacy of the IRS guidance on this rule. Treas. Reg. 1.197-2(h) that explains the anti-churning rule along with examples 27 to 31 at Treas. Reg. 1.197-2(j) comprise over 8,200 words. In contrast, Treas. Reg. 1.197-2(b) defining Section 197 intangible is just over 1,700 words in length.

President Obama’s revenue proposals for FY 2017 included repeal of the Section 197 anti-churning rule. The rationale provided for this change follows:

“The rules under section 197(f)(9) are complex. Because it has been more than 20 years since the enactment of section 197, most of the intangibles that exist today did not exist during the transition period and, thus, would not be subject to section 197(f)(9). Even though the number of intangibles subject to section 197(f)(9) may be minor, taxpayers must nevertheless engage in due diligence to determine whether such intangibles exist and then navigate the complex rules of section 197(f)(9). Accordingly, the complexity and administrative burden associated with section 197(f)(9) outweighs the current need for the provision.”⁹

The fact that Section 197 was enacted almost 30 years ago, simplicity and growing prevalence and importance of intangible assets support repeal of the Section 197(f)(9) anti-churning rule.

IV. FAVORABLE DEPRECIATION RULES SHOULD NOT APPLY ONLY TO TANGIBLE BUSINESS ASSETS

Since at least the 1990s, the importance of intangible assets such as software and intellectual property has become a significant element of economic activity. In 2006, the Federal Reserve Board determined that “investment in intangible assets in the United States exceeds all investment in tangible property and, if properly accounted for, would raise measured productivity growth significantly.”¹⁰

Despite the importance of intangible assets to most businesses, favorable tax rules, such as bonus depreciation (Section 168(k)) and the expensing election of Section 179 only apply to tangible personal property (certain software is included in Section 179). Inclusion of specified acquired intangible assets for the Section 179 expensing election (particularly those with a clear life under 15 years or separately acquired (not along with other assets constituting a trade or

⁹ Dept. of the Treasury, General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals, Feb. 2016, page 247; <https://home.treasury.gov/system/files/131/General-Explanations-FY2017.pdf>. This proposal was also included in the Administration’s FY 2016, FY 2015 and FY 2014 revenue proposals. For similar reasons, repeal of the anti-churning rule has also been proposed by the AICPA; Compendium of Tax Legislative Proposals 2023, Feb. 7, 2023, page 138; <https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-aicpa-cover-letter-and-compendium-2023.pdf>.

¹⁰ National Research Council, *Intangible Assets: Measuring and Enhancing Their Contribution to Corporate Value and Economic Growth*, 2009, page 1 1.

business) would offer simplification for small businesses and encourage further investment in these important assets.

Advancements in digital and other intangible assets have often led to advancements in hardware. Also, many intangibles, such as an acquired domain name, are as important to business operations as manufacturing equipment. Thus, when favorable tax depreciation rules are provided for tangible personal property (such as more rapid depreciation or shorter lives), consideration should also be given to what acquired intangible assets should also be afforded favorable amortization provisions.

V. NEED FOR A STUDY WITH PUBLIC COMMENTS

Given the expansion of the types of intangible assets used by businesses today relative to 1993, and the continuing innovation and changes in the digital world, it would be informative to study today's intangibles, similar to what the GAO¹¹ did leading up to the enactment of Section 197. This would allow for review of categorization and description of these assets, appropriate amortization lives, treatment of self-created intangibles for use in the business and acquisition of any intangible that is not part of the acquisition of a trade or business. Additional benefits of a formal study include that it could be informed by economic analysis and public comment.

¹¹ General Accounting Office, *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, GAO/GGD-91-88, August 1991, page 3; <https://www.gao.gov/assets/ggd-91-88.pdf>. In addition, the Treasury Department issued a comprehensive study on depreciation in July 2000—*Report to The Congress on Depreciation Recovery Periods and Methods*, which is another good example of benefits to be derived from focused research and discussion, along with public comments, on how to be sure amortization rules for today's intangible assets is appropriate. This 2020 report is available at <https://home.treasury.gov/system/files/131/Report-Depreciation-Recovery-Periods-2000.pdf>.