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DAYS OF OUR LIVES: THE IMPACT OF SECTION 197 ON THE DEPRECIATION OF COPYRIGHTS, PATENTS, AND RELATED PROPERTY

Mary LaFrance*

I. INTRODUCTION

For federal income tax purposes, owners of intangible property generally must capitalize the costs of creating or acquiring that property. In the past, the tax rules for recovering these capitalized costs through depreciation\(^1\) deductions varied greatly according to the nature of the intangible. Certain types of acquired intangibles—notably, goodwill and

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* Associate Professor of Law, Florida State University College of Law. The author would like to thank John Coverdale and Don Weidner for their helpful comments on an earlier draft of this Article, Lori Berg, Mary Booth, Sharon Calix, and Charles Webb for their valuable research assistance, Connie Clark and Joe Traina for their outstanding manuscript support, and the College of Law for generously funding this research.

1. The term “depreciation” is used throughout this Article to refer to various methods of accounting for the exhaustion of interests in filmed entertainment and similar assets. Although the term “amortization” is often used in this context because many of these interests consist largely or entirely of intangible property, see I.R.C. § 197 (1994), for tax purposes, interests in films, sound recordings, or similar property are not always treated as intangibles. See, e.g., I.R.C. § 263A(b) (1994) (for purposes of uniform capitalization rules, “tangible personal property” includes “a film, sound recording, video tape, book, or similar property”); see also infra note 26 (discussing interests in entertainment products as tangibles and intangibles). In fact, many of the assets discussed in this Article consist of both tangible property (a film negative or prints, a phonorecord, a computer disk, a CD-ROM, or a videocassette) and intangible property (copyright, contract, or trademark rights). For these reasons, and for simplicity, only the term “depreciation” will be used here.
going concern value—were nondepreciable. In contrast, taxpayers purchasing interests in copyrights or patents could depreciate those assets under the straight-line method or, in most cases, could opt for more rapid cost recovery under the income forecast method.\(^2\)

In the Omnibus Budget Reconciliation Act of 1993, Congress greatly enlarged the class of depreciable intangibles.\(^3\) The new rules, which are codified in section 197 of the Internal Revenue Code,\(^4\) allow taxpayers to depreciate virtually any intangible. Under certain circumstances, however, the new depreciation rules also apply to copyrights, patents, and other forms of intellectual property that were already depreciable under prior law. The effects of this change are particularly acute when the intangible in question was previously eligible for the income forecast method of depreciation, because the method prescribed by section 197 spreads depreciation deductions over a fixed, continuous recovery period, whereas the income forecast method allocates depreciation according to the actual income produced by the asset. Motion pictures and sound recordings are two notable examples of assets affected by these changes, although virtually any intangible property that derives its value from a copyright or patent may feel the impact.

This Article explores the effect of section 197 on the depreciation of property that was previously eligible for income forecast depreciation.\(^5\) It appears clear that in certain cases Congress intended to preserve the availability of the income forecast method—for example, where a taxpayer acquires an interest in a single unreleased motion picture or sound recording, or an individual patent. In other cases, however, Congress clearly intended section 197 to replace the income forecast method—for example, where a taxpayer acquires an interest in a patent or copyright in the course of acquiring the assets of an entire business. In between these two clear-cut scenarios, however, there are many

2. See infra part III.
5. The analysis and recommendations set forth in this Article with respect to income forecast property would also apply to property that is depreciable under the “sliding scale” method which the Tax Court approved in KIRO, Inc. v. Commissioner, 51 T.C. 155, 170 (1968), acq. in result, 1974-2 C.B. 3. The sliding scale method is a specialized application of the income forecast method which applies to television programming licenses. Id. at 159-60.
common situations in which the preemptive effect of section 197 is less clear—for example, where a taxpayer acquires rights in a previously-released film, or acquires several discrete assets in a single transaction, such as a television series, a music catalog, a film library, or even a group of patents. These uncertainties exist because the statute treats copyrights, patents, and related interests differently according to whether the intangible property is "acquired separately" or as part of an acquisition of a substantial portion of a trade or business, and because the legislative history suggests that a taxpayer will be found to have acquired a substantial portion of a trade or business any time the transferred assets include trademarks or other indicia of goodwill.

Neither section 197 nor its legislative history adequately addresses the large number of intellectual property-based products which contain a substantial goodwill component even when they are acquired individually rather than as part of a going concern. In addition, the legislative history cites simplicity of administration as the sole reason why patents, copyrights, and related interests which were previously eligible for income forecast depreciation are now rendered ineligible for that method whenever they are acquired as a substantial part of a trade or business rather than individually.

Accordingly, this Article evaluates the impact of section 197 on acquired interests in films, music, books, sound recordings, patents, and other intellectual property-based assets that would otherwise be eligible for income forecast depreciation. The Article observes that it can be extremely difficult to determine whether a particular acquisition is subject to section 197. In addition, mandating fifteen-year straight-line depreciation for assets that otherwise could be depreciated under the income forecast method may lead to a mismatching of the income and expense related to those assets. The Article concludes by recommending that the income forecast method be reinstated for acquired interests in patents, copyrights, and other eligible property without regard to whether, in a particular case, those interests are deemed to be "acquired separately."

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6. This problem would arise even if the group of assets transferred included only one intangible. For example, acquiring a single patent along with tangible plant and equipment could present the same problem because the patent might not be treated as "acquired separately" for purposes of the exclusion from the definition of § 197 intangibles. See I.R.C. § 197(e)(4) (1994).

7. See infra notes 65-70 and accompanying text.

8. See infra note 96 and accompanying text.

9. See Michael J. Douglass, Tangible Results for Intangible Assets: An Analysis of New Code Section 197, 47 TAX LAW. 713, 752-55 (1994) (arguing that this mismatching is preferable to providing multiple amortization periods).
II. PURPOSE AND HISTORY OF SECTION 197

Congress enacted section 197 in order to simplify the rules for deprecating intangibles and to reduce the number of controversies arising from the need to determine which intangibles are depreciable and what their recovery periods should be. The statute achieves these goals by imposing the fifteen-year straight-line method on most acquired intangibles. In general, before section 197 was enacted, the capitalized cost of an acquired intangible was depreciable only when the taxpayer could establish that the asset was distinct from goodwill or going concern value and had a limited and ascertainable useful life. The vagueness of this standard led to frequent administrative appeals and litigation.


11. See Newark Morning Ledger, 113 S. Ct. at 1672 & n.1, 1675; Ralph W. Fullerton Co. v. United States, 550 F.2d 548, 550 (9th Cir. 1977); Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1247 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974); Citizens & Southern, 91 T.C. at 492-93; Concord Control, Inc. v. Commissioner, 35 T.C.M. (CCH) 1345, 1357 (1976) (holding that purchase price allocable to going concern value was nondepreciable), aff'd, 615 F.2d 1153 (6th Cir. 1980); Treas. Reg. § 1.167(a)-3 (1960); Rev. Rul. 74-456, 1974-2 C.B. 65. See generally STAFF OF JOINT COMM. ON TAXATION, 102D CONG., 1ST SESs., DESCRIPTION OF PROPOSALS RELATING TO THE FEDERAL INCOME TAX TREATMENT OF CERTAIN INTANGIBLE PROPERTY (H.R. 3035, H.R. 1456, & H.R. 563) 5 (Comm. Print 1991) [hereinafter DESCRIPTION OF PROPOSALS] (describing these restrictions on depreciation of an acquired intangible asset).

Whereas copyrights and patents have ascertainable useful lives, in most cases unpatented inventions, trademarks, trade names, and franchises are deemed to have indeterminate useful lives and, prior to section 197, were generally found to be nondepreciable (subject to limited statutory exceptions).
There has generally been less controversy over depreciation of taxpayer-produced (or "self-created") intangibles. In some cases, the cost of creating such intangibles is expensed—for example, where they reflect advertising expenses used to generate goodwill, or training costs used to enhance the value of workforce in place, or where a taxpayer elects to deduct research and development expenditures under section 174. In other cases, creation costs must be capitalized—for example, the

or where it lacked a determinate useful life); DESCRIPTION OF PROPOSALS, supra note 11, at 11 (similar).

The enactment of § 1253 allowed the cost of certain acquired trademarks, trade names, and franchises to be recovered through annual deductions. When a trademark, trade name, or franchise is sold for serial payments contingent on the use, productivity, or disposition of the asset, the payments are typically deductible as trade or business expenses. I.R.C. § 1253(d) (1994). Before enactment of § 197, § 1253 permitted 10- and 25-year amortization under certain other circumstances. Id. § 1253(d)(2), (3) (before amendment by Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13, 107 Stat. 532, 539 (codified at 26 U.S.C § 197 (1994))). In all other cases, the cost of acquiring a trademark, trade name, or franchise must be capitalized. I.R.C. § 1253(d)(2) (1994); see DESCRIPTION OF PROPOSALS, supra note 11, at 11-12 (discussing § 1253); Rev. Rul. 74-302, 1974-1 C.B. 238 (applying § 1253). Annual licensing fees remain deductible under I.R.C. § 162 (1994).

Before § 197 was enacted, the costs of acquiring unpatented inventions, trade secrets, and other types of "know-how" were generally treated as nondepreciable because the assets' useful lives were deemed to be indeterminate, like goodwill. See Kaltenbach v. United States, 66 Ct. Cl. 581, 587-88 (1929); Sarkes Tarzian, Inc. v. United States, 159 F. Supp. 253, 256 (S.D. Ind. 1958); Graham v. Commissioner, 76 T.C. 853, 859 (1981); Yates Indus. v. Commissioner, 58 T.C. 961, 973-34 (1972), aff'd without opinion, 480 F.2d 920 (3d Cir. 1973); Burde v. Commissioner, 43 T.C. 252, 269-70 (1964), aff'd, 352 F.2d 995 (2d Cir. 1965), cert. denied, 383 U.S. 966 (1966); Hershey Mfg. Co. v. Commissioner, 14 B.T.A. 867, 876-77 (1928), modified, 43 F.2d 298 (10th Cir. 1930); Treas. Reg. § 1.167(a)-3 (1960). But see Liquid Paper Corp. v. United States, 2 Cl. Ct. 284, 299 (1983) (holding that where formula has determinable useful life, it is depreciable); Best Lock Corp. v. Commissioner, 31 T.C. 1217, 1234 (1959) (allowing annual depreciation deduction with respect to patent applications where deduction reflects annual payment contractually fixed as a percentage of annual earnings derived from patent application); Kraft Foods Co. v. Commissioner, 21 T.C. 513, 591-93 (1954) (allowing depreciation of patent applications), rev'd on other grounds, 232 F.2d 118 (2d Cir. 1956); Rev. Rul. 67-136, 1967-1 C.B. 58, 59 (similar).

15. See Rev. Rul. 92-80, 1992-2 C.B. 57 (reiterating rule that advertising expenses are deductible under § 162 even though they may create benefits that extend substantially beyond the current taxable year).

16. See, e.g., Knoxville Iron Co. v. Commissioner, 18 T.C.M. (CCH) 251, 263 (1959) (holding that personnel training costs were deductible when incurred); DESCRIPTION OF PROPOSALS, supra note 11, at 18.

creation costs of most copyrights \(^{18}\) and any creation costs of patents that are not deducted under section 174. \(^{19}\) In the case of taxpayer-created copyrights and patents, just as in the case of acquired patents and copyrights, capitalized costs are depreciable. \(^{20}\) In contrast, in the case of a trademark, trade name, or franchise, creation costs that are ineligible for expensing must generally be capitalized, \(^{21}\) but prior to section 197's enactment, these capitalized costs were typically treated as nondepreciable. \(^{22}\)

Section 197 does not change the rules dictating whether the cost of creating or acquiring a particular intangible asset should be capitalized or expensed. However, it does change the rules for determining whether, and by what method, any of the capitalized costs can be depreciated. \(^{23}\)

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22. Id. § 263; Treas. Reg. § 1.1167(a)-3 (1960); Rev. Rul. 89-23, 1989-1 C.B. 85 (capitalized package design costs were nondepreciable because useful life of design was indeterminate). Costs incurred in creating or defending a trademark were formerly depreciable under § 177, which was repealed by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 241(a), 100 Stat. 2085, 2181. See, e.g., Georator Corp. v. United States, 485 F.2d 283, 285-86 (4th Cir. 1973), cert. denied, 417 U.S. 945 (1974), abrogation recognized by NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982); see also Rev. Rul. 79-333, 1979-2 C.B. 110 (legal fees incurred in infringement proceedings were amortizable under § 177 so long as taxpayer made timely election).

23. At times it may be difficult to determine whether a particular asset (such as a cartoon figure or musical jingle) is primarily a copyright or primarily a trademark. The latter is always subject to § 197, even when self-created, while a self-created copyright is not. However, § 197 itself did not create this uncertainty. See infra note 76 (discussing interests in copyrighted works acquired...
Section 197 now allows taxpayers to depreciate the capitalized cost of virtually any intangible—including such formerly nondepreciable assets as goodwill, going concern value, franchises, trademarks, and trade names—whether created or purchased by the taxpayer.24 It thus reduces the number of situations in which it is necessary to determine the useful life of a particular intangible, and diminishes the incentive taxpayers once had to characterize acquired intangibles as assets distinguishable from goodwill and going concern value.

As discussed in Part IV, however, in many cases section 197 requires taxpayers to depreciate all intangibles acquired in a single transaction under the fifteen-year straight-line method, even though some of those intangibles, if acquired separately, would have been eligible for alternative depreciation methods. Although lumping these intangibles together for depreciation purposes does provide for simplicity of administration, in certain cases this causes a mismatching of income and expense by imposing a recovery period that does not correspond to the asset's useful life, and by requiring depreciation to be spread evenly over a fixed recovery period even where the associated income stream varies significantly from one year to the next.25 This is particularly true of those intangibles, such as copyrights and patents, which would otherwise be eligible for income forecast depreciation. In addition, the lack of guidance for determining when such an intangible is "acquired separately" reintroduces some of the complexity which section 197 was supposed to eliminate.

III. DEPRECIATION OF INTELLECTUAL PROPERTY UNDER THE INCOME FORECAST METHOD

As discussed in Part II, before enactment of section 197, certain intellectual property interests, including copyrights and patents, were depreciable even though other intangibles,26 such as goodwill and going

25. See Douglass, supra note 9, at 752-55.
26. Although interests in motion pictures, television films, videotapes, and master sound recordings are treated as intangibles in § 197, courts have treated them as tangibles for purposes of the investment tax credit ("ITC"). See, e.g., EMI N. Am. Holdings, Inc. v. United States, 675 F.2d 1068, 1069 (9th Cir. 1982) (master sound recordings qualify for ITC); Bing Crosby Prods., Inc. v. United States, 588 F.2d 1293, 1299 (9th Cir. 1979) (similar); Walt Disney Prods. v. United States, 549 F.2d 576, 580 (9th Cir. 1976) (master negatives of feature films qualify for ITC). Congress eventually resolved the conflict with an express provision making only "qualified films" eligible for the ITC. I.R.C. § 48(k) (1988) (repealed); Treas. Reg. § 1.48-8 (1988) (removed by T.D. 8474, 58
concern value, were not. In fact, copyrights and patents have long been eligible for particularly rapid depreciation under the income forecast method whenever the asset in question produces higher income in its early years of exploitation than in later years. Over time the government has extended this method to a wide variety of copyright-based products, such as motion pictures, books, and sound recordings.

The income forecast method works as follows: During each year that an asset is used in income-producing activities, the taxpayer recovers a fraction of its basis (less its estimated salvage value). That fraction is derived from the following calculation: The taxpayer must estimate in advance the gross income which the asset will generate for the taxpayer during its lifetime. Then, in each taxable year, the taxpayer can deduct a percentage of the capitalized cost which corresponds to the percentage of the estimated lifetime income generated during that year. Thus, for a given taxable year, the numerator of the income forecast fraction is the income actually received by the taxpayer from exploiting the asset during that year, and the denominator is the estimated total income to be derived.


For depreciation purposes, there is some uncertainty over whether films (or interests therein) are tangible assets. Courts have never reached agreement. See, e.g., DiPiero v. Commissioner, 57 T.C.M. (CCH) 71, 79-80 (1989) (treating film as tangible, but right to participate in gross receipts as intangible); Madden v. Commissioner, 57 T.C.M. (CCH) 84, 91 (1989) (same); Walt Disney, 549 F.2d at 580 (noting that taxpayer depreciated its films under income forecast method—"a scheme generally used for depreciating intangible personal property"—without deciding whether taxpayer’s characterization was correct). In a 1979 Revenue Ruling and a 1978 General Counsel Memorandum ("GCM"), the IRS took the position that films and similar property are intangibles for depreciation purposes. Rev. Rul. 79-285, 1979-2 C.B. 91 (disapproving use of sliding scale method for depreciation of manuscripts); Gen. Couns. Mem. 37,800 (Dec. 27, 1978) (similar). In the accelerated cost recovery system ("ACRS") rules of § 168, Congress implicitly treated motion pictures and videotapes as tangible property when it listed them as exceptions to the general rule that ACRS was applicable to "any tangible property." I.R.C. § 168(a), (f)(3) (1994); see Comshare, Inc. v. United States, 27 F.3d 1142, 1146-47 (6th Cir. 1994) (holding that "tangible personal property" has an expansive meaning in the Code, encompassing motion pictures and television films).

In the copyright context, of course, the intangibles contained in films and other entertainment products are distinguished from their tangible aspects. See 17 U.S.C. § 202 (1994) (distinguishing ownership of copyright from ownership of physical object in which it is embedded).

27. The salvage value would depend on whether the taxpayer normally disposes of a film while it still has substantial value or exploits each film until its commercial potential is exhausted. See Rev. Rul. 60-358, 1960-2 C.B. 68, 69-70.
from the asset during its useful life.\textsuperscript{28} The estimated total income is based on the conditions existing at the end of the year to which the depreciation deduction applies. If these conditions change, so that the original expectations prove inaccurate, any over-or under-estimates of the asset's total income stream can be corrected by changing the denominator of the fraction in each year that an error becomes apparent.\textsuperscript{29}

The Treasury first authorized the use of the income forecast method for "television films, taped shows for reproduction, and other property of a similar character."\textsuperscript{30} In that ruling, the government reasoned that time-based depreciation methods—such as the straight-line method—would not clearly reflect the income associated with such assets. A successful film, for example, might continue to produce substantial revenue over a number of years, while an unsuccessful one might produce little or no revenue after its initial year of service. The ruling did not distinguish between the intangible and tangible components of the assets, nor did it distinguish between ownership of all the rights in a particular asset and ownership of limited exploitation rights such as a license or profit participation.

Subsequent rulings approved the income forecast method for other

\textsuperscript{28} Algebraically, the formula can be expressed as follows:

\[ D = \frac{(C-S) \times Y}{T} \]

- \( T \) = total anticipated income from the asset
- \( Y \) = income from the asset during Year \( X \)
- \( C \) = asset's cost
- \( S \) = asset's salvage value
- \( D \) = depreciation allowable for Year \( X \)


Rev. Rul. 60-358 defined the "income" to be included in the denominator of the income forecast fraction as "the forecasted or estimated total income to be derived from the films during their useful life, including estimated income from foreign exhibition or other exploitation of such films... less the expense of distributing the films, not including depreciation." \textit{Id.} at 69.

However, according to a subsequent interpretation by the IRS, this income stream is not as all-inclusive as the language of the Revenue Ruling would suggest. Certain sources of income that are deemed "speculative" are excluded from the income forecast fraction until there is greater certainty that they will be realized. See Rev. Proc. 71-29, 1971-2 C.B. 569, 569 (ruling that income from certain secondary markets for motion picture films and television films and series could be excluded from income forecast formula as too speculative). Although merchandising revenues may represent a substantial portion of the income stream of certain income forecast properties—motion pictures and television films, in particular—the IRS takes the position that merchandising income should be completely excluded from the income forecast calculation. Tech. Adv. Mem. 79-18-012 (Jan. 24, 1979).

intellectual property-based products, including theatrical motion pictures, books, patents, master sound recordings, musical compositions, rental videocassettes, and most recently, video games. The Tax Court has repeatedly endorsed the use of the income forecast method for films, finding that it produces a clear reflection of income. Courts have also approved the method for certain interests that constitute less than full ownership of one of these assets—for example, a contractual right to participate in the gross receipts or net profits of a motion picture. The rationale of these authorities suggests that the method should be appropriate for other categories of depreciable property which generate an income stream so uneven that the passage of time is not the best measure of the property’s usage. Thus, the list of property eligible for income forecast depreciation could continue to

33. Id.
34. Id.
35. Tech. Adv. Mem. 85-01-006 (Sept. 24, 1984) (noting that the ruling is limited to copyrighted musical compositions which “generate an uneven flow of income similar to that described in Rev. Rul. 60-358”).

[A]ssets . . . for which use of the income forecast method has been approved, have the following attributes in common: (1) the physical life of the asset is largely irrelevant to its income producing ability; (2) each asset has unique income-producing ability; and (3) the useful life of the asset is measured in terms of its income producing ability.

expand as new forms of intellectual property are developed. Subject to the limits now imposed by section 197, the income forecast method applies to both self-created and acquired depreciable assets.

Other than the income forecast method, depreciation methods which allow accelerated deductions in the early years of an asset's useful life are generally inapplicable to patents, copyrights, or similar assets which, although tangible in some respects, derive their value largely from patents or copyrights. Examples include interests in motion pictures, television films, videotapes, and sound recordings. Such assets are ineligible for accelerated depreciation, and must therefore be depreciated under the straight-line method unless the taxpayer can establish the reasonableness of another method, such as the income forecast method. For many, if not most, taxpayers, the income forecast method

41. Although the income forecast method would seem appropriate for computer software, that application is statutorily barred. Section 197 applies to acquired software that is customized, exclusively licensed, unavailable to the general public, or acquired in a transaction that involves the acquisition of assets constituting a substantial portion of a trade or business. I.R.C. § 197(e)(3)(A) (1994). Other newly acquired software is subject to three-year depreciation. Id. § 167(b)(1)-(2). H.R. REP. No. 111, supra note 10, at 767; S. REP No. 36, 103d Cong., 1st sess. 226 (1993). Before § 197 was enacted, software could be depreciated over five years or less. See Rev. Proc. 69-21, 1969-2 C.B. 303.


44. Treas. Reg. § 1.167(b)-1(a) (1960). In the case of certain film rights licensed for a limited number of television showings (rather than a limited period of time with unlimited showings), the Tax Court has approved use of a variation on the income forecast method known as the “sliding scale” method. Under this method, the licensee can allocate depreciation on a graduated basis, with greater amounts allocated to the earlier showings, reflecting the fact that the earlier showings are worth a larger portion of the license fee than the later showings. See KIRO, Inc. v. Commissioner, 51 T.C. 155, 170-74 (1968), aff’d in result, 1974-2 C.B. 3. In other cases, this method has been disallowed in favor of a more standard application of the income forecast method. See Schwartz v. Commissioner, 54 T.C.M. (CCH) 11, 25-26 (1987) (disallowing sliding scale method where partnership owned only a contractual right to participate in film’s gross receipts after recoupment of production costs), aff’d without opinion, 930 F.2d 920 (9th Cir. 1991) (reported in full at 1991
is the only means available to achieve faster cost recovery.45

U.S. App. LEXIS 7415 (9th Cir. Apr. 19, 1991); Garner v. Commissioner, 54 T.C.M. (CCH) 824, 836 (1987) (where taxpayer acquired television programs, court found no evidence that the number of authorized television broadcasts was limited and no evidence that advertising revenues diminished for rebroadcasts); see also Rev. Rul. 79-285, 1979-2 C.B. 91, 92 (disallowing sliding scale method where taxpayer purchased all rights to book manuscript, patent, and master recording).

At one time the income forecast method was the only depreciation method available for motion pictures and certain other properties. Embodied in former § 280, this rule was aimed at certain motion picture tax shelters. See Law v. Commissioner, 86 T.C. 1065, 1104 n.24 (1986); Estate of Helliwell v. Commissioner, 77 T.C. 964, 990-91 (1981); S. REP. No. 938, 94th Cong., 2d Sess. 9, 71-79 (1976).

Other than the income forecast method and the sliding-scale method, the straight-line method is the only method available for depreciating motion pictures, videotapes, master sound recordings, and similar copyright-based properties. See Green v. Commissioner, 57 T.C.M. (CCH) 1333, 1350 (1989) (upholding Commissioner's decision that taxpayer must switch from declining balance method to income forecast method for motion picture); DiPiero v. Commissioner, 57 T.C.M. (CCH) 71, 83 (1989) (holding that "straight-line method is applicable to intangible properties"); Madden v. Commissioner, 57 T.C.M (CCH) 84, 95 (1989) (declining balance method unavailable for contractual right to participate in film's gross receipts, while straight line method would be appropriate); Law, 86 T.C. at 1103 (holding that either straight-line or income forecast method may be used to depreciate contractual right to participate in film's gross receipts and that the declining balance method is unavailable for intangibles); Inter-City Television Film Corp. v. Commissioner, 43 T.C. 270, 292 (1964) (cost recovery method unacceptable for television films and film rights); Rev. Rul. 89-62, 1989-1 C.B. 78, 79 (accelerated depreciation unavailable for rental videotapes; taxpayer must use straight-line or income forecast method); Rev. Rul. 67-379, 1967-2 C.B. 127, 129 (baseball players' contracts are ineligible for accelerated depreciation); Rev. Rul. 60-358, 1960-2 C.B. 68, 68 (as amplified by, Rev. Rul. 64-273, 1964-2 C.B. 62) (cost recovery method unacceptable and income forecast acceptable for television films and film rights); Tech. Adv. Mem. 78-02-004 (Sept. 28, 1977) (accelerated depreciation unavailable for motion pictures and television films because they are intangibles, even though treated as tangibles for purposes of investment tax credit); see also I.R.C. § 168(f)(1)(B) (1994) (making accelerated depreciation unavailable for any property which, in its first year of use by the taxpayer, "is properly depreciated under . . . any method of depreciation not expressed in a term of years"). Prior to 1986, certain sound recordings were eligible for accelerated depreciation under ACRS. I.R.C. § 48(r)(1) (1982); Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 113(c)(1), 98 Stat. 494, 635 (codified at 26 U.S.C. § 48 (1994)).

45. In general, the income forecast method is beneficial to taxpayers seeking rapid recovery of their film production or acquisition costs. This is because the largest part of a film's income stream typically occurs in the early years of its release. See HAROLD L. VOGEL, ENTERTAINMENT INDUSTRY ECONOMICS 73 (2d ed. 1990); see also Durkin v. Commissioner, 872 F.2d 1271, 1277-78 (7th Cir.) (discussing typical time frames for theatrical, videocassette, and television release), cert. denied, 493 U.S. 824 (1989). Unless a film produces little or no revenue in its early years, the income forecast method will provide faster basis recovery than the straight-line method.

Under the straight-line method, a film's costs are deducted over its useful life, defined as the period during which the asset may reasonably be expected to be useful in the taxpayer's income-producing activity. See Treas. Reg. § 1.167(a)-1(b) (1972). Few films are depreciated under this method. See SCHUYLER M. MOORE, THE FILMED ENTERTAINMENT INDUSTRY ¶ 403.021 (Lawrence M. Stone ed., 1990). The salvage value of filmed entertainment may be reduced by 10% of basis, which for many films effectively eliminates salvage value from the straight-line calculation. Treas. Reg. § 1.167(a)-1(c) (1972).

In terms of years, the useful life of a film is difficult to predict with accuracy. Although
IV. THE IMPACT OF SECTION 197 ON PREVIOUSLY DEPRECIABLE INTANGIBLES

When a particular intangible falls within the scope of section 197, it is now subject to straight-line depreciation over a fifteen-year period, regardless of the property's anticipated income stream or useful life.\textsuperscript{46} With respect to any intangible which generates most of its income early in its useful life, such as a motion picture or other intellectual property-based asset, the preclusion of the income forecast method could have significant tax consequences.

Section 197 applies to specified categories of intangibles that are held in connection with a trade or business or other income-producing activity,\textsuperscript{47} including, among others,\textsuperscript{48} goodwill,\textsuperscript{49} copyrights,\textsuperscript{50} patents,\textsuperscript{51} and "similar item[s],"\textsuperscript{52} certain computer software,\textsuperscript{53} covenants taxpayers have been known to use shorter lives, lives of 5-12 years appear to be typical. See Bailey v. Commissioner, 993 F.2d 288, 291 (2d Cir. 1993) (noting Tax Court's finding of 10-year useful life); Upham v. Commissioner, 923 F.2d 1328, 1336 (8th Cir. 1991) (upholding Tax Court determination of eight-year useful life, and noting expert testimony that a film released in 1981 could be expected to produce revenues for about 12 years); Durkin, 872 F.2d at 1278 (upholding tax court's finding of six-year useful life). See generally MOORE, supra (collecting authorities). One commentator reports that film limited partnerships have sometimes used a four-year life, reasoning that revenues which accrue after four years are so speculative that they would have been excluded from the anticipated revenue stream under the income forecast method. See id. For a discussion of amounts excluded from estimated lifetime revenues under the income forecast method, see supra note 29. But see Durkin, 872 F.2d at 1278 (rejecting four-year useful life claimed by taxpayer).

In some cases, the straight-line method will benefit a taxpayer more than the income forecast method. If the taxpayer receives no income from the film during a given year (for example, if distribution expenses equal or exceed gross receipts), the income forecast method allows no depreciation deduction for that year. See, e.g., Fox Park Corp. v. Commissioner, 50 T.C.M. (CCH) 917, 922 (1985). This is occasionally a problem even for a relatively successful film, if the taxpayer reports on the cash method and encounters difficulty in collecting receipts. See, e.g., Gordon v. Commissioner, 766 F.2d 293, 298 (7th Cir. 1985); Wildman v. Commissioner, 78 T.C. 943, 951 (1982); Rev. Rul. 78-28, 1978-1 C.B. 61, 61. If a film never generates any net income after distribution expenses, the straight-line method allows no depreciation deductions at all, and the taxpayer can recover the asset's basis only by selling or abandoning the property.

\textsuperscript{47} I.R.C. § 197(c)(1)(B) (1994).
\textsuperscript{48} See id. § 197(d)(1) (defining "section 197 intangible").
\textsuperscript{49} Id. § 197(d)(1)(A).
\textsuperscript{50} Id. § 197(d)(1)(C)(iii).
\textsuperscript{51} Id.
\textsuperscript{52} Id.
not to compete,54 and "any franchise, trademark, or trade name."55 Because section 197 is mandatory rather than elective, any property to which it applies cannot be depreciated under an alternative method such as the income forecast method even if the alternative approach would, from an economic perspective, provide a clearer reflection of income.

Certain intangibles fall within section 197 regardless of whether they are acquired or self-created56—for example, trademarks, trade names, and franchises.57 Others are subject to section 197 only when they are acquired rather than self-created. Within this latter group, certain acquired intangibles are subject to section 197 regardless of how they are...
acquired; notable examples are goodwill and going concern value.\textsuperscript{58} Another class of intangibles is subject to section 197 only when the taxpayer has obtained the assets in the course of acquiring a trade or business or a "substantial portion thereof."\textsuperscript{59} If an intangible of this type is "acquired separately,"\textsuperscript{60} section 197 does not apply.

This "acquired separately" exception applies to several types of assets, many of which are closely related to the entertainment industry—notably, "[a]ny interest in a film, sound recording, video tape, book, or similar property,"\textsuperscript{61} "[a]ny interest in a patent or copyright,"\textsuperscript{62} and, to the extent authorized by future Treasury Regulations, certain contractual rights that are fixed in amount or endure less than fifteen years.\textsuperscript{63} Thus, if any of these interests are acquired separately, the acquiring party will not be compelled to use fifteen-year straight-line depreciation.\textsuperscript{64}

The question regarding whether section 197 applies to an acquired (as opposed to self-created) intangible thus initially depends on the nature of the intangible—for example, customer lists versus copyrights. For intangibles covered by the "acquired separately" exception, the determination then turns on the circumstances of the acquisition—i.e., whether or not it is separately acquired. For these assets, section 197 applies only

\textsuperscript{58} To derive a complete list, compare \textit{id.} § 197(d) (listing all "section 197 intangible[s]") with \textit{id.} § 197(e)(4) (listing assets exempt from § 197 when "acquired separately").
\textsuperscript{59} \textit{id.} § 197(e)(4).
\textsuperscript{60} \textit{id.}
\textsuperscript{61} \textit{id.} § 197(e)(4)(A).
\textsuperscript{62} \textit{id.} § 197(e)(4)(C).
\textsuperscript{63} \textit{id.} § 197(e)(4)(D). If implemented, the exception will apply to contractual rights which have a fixed duration of less than 15 years, or which are fixed as to amount and would otherwise be subject to recovery under a method similar to the unit-of-production method. \textit{id.} No such regulation has been promulgated at this time. The income forecast method might qualify as a method similar to the unit-of-production method, which depreciates property according to the rate at which it is used. See \textit{Panhandle E. Pipe Line v. United States}, 408 F.2d 690, 716 (Ct. Cl. 1969) (explaining unit-of-production method); \textit{Tax Treatment of Intangible Assets: Hearing on S. 1245, H.R. 3035, and H.R. 4210 Before the Senate Comm. on Finance}, 102d Cong., 2d Sess. 170 (1992) [hereinafter \textit{Senate Hearings}] (statement of Motion Picture Association of America, Inc.) (drawing above analogy between income forecast method and unit-of-production method). However, it is questionable whether most depreciable intellectual property rights could be considered "fixed as to amount."
\textsuperscript{64} With respect to two of these exempt categories—copyrights and contractual rights—§ 167 provides that the depreciation deduction shall be computed in accordance with regulations prescribed by the Secretary. I.R.C. §167(f)(2) (1994) (as amended by Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,261(b)(1), 107 Stat. 312, 538). However, there is no similar provision for the first category—films, sound recordings, etc. This is somewhat confusing, since an interest in a "film, sound recording, video tape, book, or similar property" by definition includes a copyright interest, and will often include contractual rights of the kind included in the "acquired separately" exception. \textit{See id.} § 197(e)(4)(A) (1994).
if the assets are acquired as part of a transaction (or a series of related transactions) in which the taxpayer acquires a “substantial portion” of a trade or business. Once a transaction is so characterized, all of the section 197 intangibles acquired in the transaction will be subject to fifteen-year straight-line depreciation under section 197 because none of them will be treated as “acquired separately.”

This presents two questions, one of interpretation and one of policy. The interpretation question is how to determine which acquisitions involve a “substantial portion” of a trade or business. The policy question is whether, once those transactions are identified, it is appropriate to apply a different, and usually less generous, depreciation method to income forecast property simply because it has not been “acquired separately.”

When Congress decided to subject income forecast property, such as copyrights and patents, to the same treatment as customer lists and goodwill whenever the intangibles in question are acquired as a substantial portion of a trade or business, it allowed the goal of tax simplification to override the goal of matching income and expense. In order to achieve this simplification, however, Congress, the Treasury, and ultimately the courts must now address the difficult question of what constitutes an acquisition of a substantial portion of a trade or business. As discussed below, in the case of certain types of income forecast property, this question may be especially controversial. The complexity of this interpretive problem, combined with the failure of the fifteen-year straight-line method to match income and expense as accurately as the income forecast method, raises a serious question as to whether income forecast property should have been included in section 197 at all.

A. Defining a “Substantial Portion of a Trade or Business”: The Role of Goodwill

Unfortunately, section 197 does not define what constitutes a “substantial portion” of a trade or business. As discussed below, this factual determination can be especially problematic any time an acquired intangible contains certain indicia of goodwill. This problem will tend to be compounded when the acquisition involves multiple assets, but it can arise even when only a single asset is acquired—for example, a single motion picture. Although this ambiguity can arise in connection with any kind of intangible covered by the “acquired separately” rule, in practice it is likely to be encountered most often in the case of interests in motion
pictures, video games, and other entertainment or education-related properties that contain significant indicia of goodwill.

The legislative history of section 197 offers only general guidance as to what constitutes a "substantial portion" of a trade or business. To determine what is a "substantial portion," the Conference Report calls for a "facts and circumstances" analysis which considers "the nature and amount of the assets acquired as well as the nature and amount of the assets retained by the transferor." The Report also offers this guidance for determining which assets constitute a "trade or business":

[A] group of assets is to constitute a trade or business if the use of such assets would constitute a trade or business for purposes of section 1060 of the Code (i.e., if the assets are of such a character that goodwill or going concern value could under any circumstances attach to the assets). In addition, the acquisition of a franchise, trademark or trade name is to constitute the acquisition of a trade or business or a substantial portion of a trade or business.

The specific reference to franchises, trademarks, and trade names in this passage is somewhat redundant, since by their nature, these are assets to which goodwill normally attaches. However, this redundancy serves to underscore Congress's apparent intent to treat any asset acquisition...

66. Id; See also Treas. Reg. § 1.1060-1T(b)(2) (1988) (expanding on the "trade or business" definition).
67. See, e.g., 15 U.S.C. § 1060 (1994) (trademark is assignable with goodwill of the business); Pignons S.A. de Mecanique de Precision v. Polaroid Corp., 657 F.2d 482, 495 n.8 (1st Cir. 1981) (use of another's trade name appropriates "the reputation, goodwill and value connected with [that] trade name") (quoting Great Scott Food Market, Inc. v. Sunderland Wonder, Inc., 203 N.E.2d 376, 379 (Mass. 1965)); Pignons, 657 F.2d at 494 (defining "trademark dilution" as "use of a mark by the defendant in a way that detracts from, draws on or otherwise appropriates the goodwill and reputation associated with the plaintiff's mark"); E.F. Prichard Co. v. Consumers Brewing Co., 136 F.2d 512, 519 (6th Cir. 1943) (trademark ownership established where claimant gives merchandise "the benefits of his name and business style"), cert. denied, 321 U.S. 763 (1944); Montgomery Coca-Cola Bottling Co. v. United States, 615 F.2d 1318, 1332 (Ct. Cl. 1980) (considering franchise as repository of goodwill); ABC v. Wahl Co., 36 F. Supp. 167, 168 (S.D.N.Y. 1940) (trademark is deemed abandoned if assigned apart from the goodwill of the business), rev'd on other grounds, 121 F.2d 412 (2d Cir. 1941); Coca-Cola Bottling Co. v. Coca-Cola Co., 269 F. 796, 806 (D. Del. 1920) ("Trade-marks and the good will [sic] of a business are inseparable."); Canterbury v. Commissioner, 99 T.C. 223, 252 (1992) ("Trademarks and trade names are the embodiment of goodwill."); Kramer v. Commissioner, 80 T.C. 768, 782 (1983) (referring to goodwill as "inextricably the essence of the valuable use of a name"); Zorniger v. Commissioner, 62 T.C. 435, 444-45 (1974) (similar to Montgomery Coca-Cola), acq. in result, 1975-1 C.B. 2, and acq. in result, 1975-2 C.B. 3. See generally 15 JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION § 59.58, at 162-63 & n.54 (1994) (collecting cases, and noting that while trademarks and franchises embody goodwill, they can be separately valued for tax purposes).
which includes a goodwill component as the acquisition of a “substantial portion of a trade or business.” Thus, for example, the presence of even a single protectable mark could cause an entire group of acquired assets to be ineligible for a depreciation method other than that of section 197, even if, had the mark been excluded from the transfer, the other assets would have qualified for the “acquired separately” exception.\footnote{\textit{The Day's of Our Lives: The Impact of Section 197 on Depreciation}, 1995, p. 399}

The presence of goodwill does not appear to be essential to finding that a particular transfer involves a substantial portion of a trade or business. Thus, even where there is no element of goodwill in the transaction, it is possible that a multiple asset transfer could fall outside the “acquired separately” exception. This might be the case, for example, where none of the taxpayer’s purchase price in a transaction can reasonably be allocated to goodwill—for example, where the taxpayer acquires all of the assets of a going concern but none of the purchase price can reasonably be allocated to a trademark, trade name, franchise, or goodwill,\footnote{\textit{See I.R.C. § 1060 (1994) (governing purchase price allocations for trademarks); Treas. Reg. § 1.1060-1T (1988) (similar).} See supra notes 56-57 and accompanying text. Thus, even where a film is created rather than acquired by the taxpayer, the presence of trademarks in the film could, at least in theory, present a problem under § 197. Because trademarks must be depreciated under the § 197 method, but copyrights and film rights are exempt, arguably any film which contains one or more trademarks (whether acquired or newly created) contains one or more intangibles which are subject to § 197.\footnote{\textit{The House Conference Report notes:} It is anticipated that the Treasury Department will exercise its regulatory authority to require any intangible property that would otherwise be excluded from the definition of the term “section 197 intangible” to be taken into account under the bill under circumstances where the acquisition of the intangible property is, in and of itself, the} perhaps because the business is poorly established or unsuccessful. If such a transfer includes income forecast property such as copyrights or patents, this property would become subject to section 197 in the buyer’s hands, even if the income forecast method would have been available to the seller.

However, in many cases the determination of whether the “acquired separately” exception applies will turn on the presence of goodwill among the acquired assets. For this issue to arise, it is not strictly necessary that more than one asset be acquired; if an element of goodwill is present in the sole asset transferred, then the buyer might be deemed to have acquired a substantial portion of a trade or business by acquiring that single asset.\footnote{\textit{See I.R.C. § 1060 (1994) (governing purchase price allocations for trademarks); Treas. Reg. § 1.1060-1T (1988) (similar).} See supra notes 56-57 and accompanying text. Thus, even where a film is created rather than acquired by a taxpayer, the presence of trademarks in the film could, at least in theory, present a problem under § 197. Because trademarks must be depreciated under the § 197 method, but copyrights and film rights are exempt, arguably any film which contains one or more trademarks (whether acquired or newly created) contains one or more intangibles which are subject to § 197.\footnote{\textit{The House Conference Report notes:} It is anticipated that the Treasury Department will exercise its regulatory authority to require any intangible property that would otherwise be excluded from the definition of the term “section 197 intangible” to be taken into account under the bill under circumstances where the acquisition of the intangible property is, in and of itself, the}
This creates uncertainty for taxpayers acquiring rights in such entertainment- or education-related products as films, television shows, toys, books, stories, comic books, musical compositions, games, video games, and multimedia works. Even a single work of this nature may include one or more protectable marks, taking the form of fictional characters (their names and/or appearance), titles, catch-phrases (for example, Yabba-Dabba-Doo; Don’t Have a Cow, Man), fictional business establishments (for example, the Daily Planet, the Lanford Lunchbox) or locations (for example, the town of Bedrock, the planet Vulcan), and other devices with sufficient secondary meaning to constitute trademarks or trade names. In addition, the mere fact that an asset such as a film

acquisition of an asset which constitutes a trade or business or a substantial portion of a trade or business.


71. Although the title of a single work is generally considered too descriptive to be federally registered as a trademark, see 15 U.S.C. § 1052(e) (1994), registration is allowed for the titles of serial works and for other titles to the extent that they are used in merchandising. See In re Cooper, 254 F.2d 611, 615-16 (C.C.P.A.) (stating that “the name or title of a book of the literary sort cannot be a trademark” but noting that series titles and names of periodicals such as magazines and newspapers have been registered), cert. denied, 358 U.S. 840 (1958); Maljack Prods. v. Goodtimes Home Video Corp., 30 U.S.P.Q. 2d (BNA) 1959, 1963 n.12 (C.D. Cal. 1994) (titles to single works cannot be registered); Salt Water Sportsman, Inc. v. B.A.S.S., Inc., 4 U.S.P.Q. 2d (BNA) 1407, 1409 (D. Mass. 1987) (noting that magazine titles can be registered) (order entered at 685 F. Supp. 12). In addition, even if it cannot be federally registered, a title with secondary meaning can qualify for trademark protection at common law and for similar protection under § 43(a) of the Lanham Act. See 15 U.S.C. § 1125(a) (1994); Tri-Star Pictures v. Leisure Time Prods., B.V., 17 F.3d 38, 43 (2d Cir.), cert. denied, 115 S. Ct. 484 (1994); Rogers v. Grimaldi, 875 F.2d 994, 998 n.3 (2d Cir. 1989); Warner Bros. Pictures v. Majestic Pictures Corp., 70 F.2d 310, 311-12 (2d Cir. 1934); Jackson v. Universal Int’l Pictures, 222 F.2d 433, 436 (Cal. 1950); Tomlin v. Walt Disney Prods., 96 Cal. Rptr. 118, 122-23 (Cal. Ct. App. 1971).

72. The terms “trademark” and “trade name” are not defined in § 197. However, the term “trademark” is also used in § 1253 of the Code. I.R.C. § 1253 (1994). The legislative history of that section mentions that the definition of that term in § 45 of the Lanham Act “…includes any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured or sold by others.” S. REP. No. 552, supra note 14, at 211 (1969), reprinted in 1969 U.S.C.C.A.N at 2246 (reporting on Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487); see 15 U.S.C. § 1127 (1994) (Lanham Act definition of trademark). The 1971 proposed regulations under § 1253 echoed that definition. Prop. Treas. Reg. § 1.1253-2(b), 36 Fed. Reg. 13,148, 13,151 (1971) (withdrawn by CO-53-92, 58 Fed. Reg. 25,587, as modified by IRS correction issued March 21, 1994). The proposed § 1253 regulations defined “trade name” as “any name used by a manufacturer or merchant to identify or designate a particular trade or business or the name or title lawfully adopted and used by a person or organization engaged in a trade or business.” Id. § 1.1253-2(c), 36 Fed. Reg. at 13,151.

Because the determination of whether a particular device has an origin-identifying function (“secondary meaning”) turns on all the facts and circumstances—notably public perception—it will not always be clear whether, at the time of acquisition, the property in question contains any
is associated with a major "name" such as a well-known writer, star, or director may cause goodwill to attach to the asset. Thus, if the Conference Report reflects the correct interpretation of the "acquired separately" provisions, a party that acquires the rights to even a single film (or similar asset) that contains some goodwill components could be treated as acquiring an asset to which section 197 applies. Indeed, it is not strictly necessary that the goodwill component be present at the time of the acquisition; according to the Conference Report, it is enough that goodwill could "under any circumstances" attach to the asset. This

73. An example would be the acquisition of film adaptation rights to a story by John Grisham or Stephen King, or the acquisition of rights in the completed film. The mere association with a well-known writer can be a virtual guarantee of future patronage, which is a widely-used definition of goodwill. See, e.g., Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670, 1683-84 (1993) (collecting cases) (Souter, J., dissenting); Silverton v. Commissioner, 36 T.C.M. (CCH) 817, 833-34 (1977) (citing additional Tax Court cases), aff'd without opinion, 647 F.2d 172 (9th Cir.) (Table), cert. denied, 454 U.S. 1033 (1981); H.R. CONF. REP. No. 213, supra note 10, at 674, reprinted in 1993 U.S.C.C.A.N. at 1363; H.R. REP. No. 111, supra note 10, at 762; S. REP No. 36, supra note 41, at 219. This would be a mere license rather than an acquisition of all rights to a trademark or trade name, since the buyer would not hold the permanent and exclusive right to use the name in question. However, the association with a well-known name would ensure that goodwill would attach, and in this context, § 197 does not appear to distinguish between licenses and ownership transfers.

74. See supra notes 66, 70 and accompanying text; see also ABA Section of Taxation, Comments Concerning Advance Notice of Proposed Rulemaking Under Section 197 of the Internal Revenue Code of 1986, reprinted in 95 TAX NOTES TODAY 16-26 (Jan. 25, 1995) (noting concerns raised by the "under any circumstances" language).

It should be noted that a taxpayer acquiring an interest in a film or similar property containing trademarks or trade names frequently does not "acquire" the marks themselves, but only a license to exploit them. For example, one who purchases all rights to a film with which Stephen King is associated does not own Stephen King's name, but typically owns a license to use that name in exploiting the film. In other cases, however, the acquirer of a film might obtain, as part of the deal, exclusive ownership of some of the marks contained in the film—for example, the name and/or likeness of a distinctive character such as R2D2 in "Star Wars."

A taxpayer may acquire an interest in a § 197 intangible which is something less than full ownership of the intangible. The "acquired separately" exception clearly applies to separate acquisitions of "[a]ny interest in a film, sound recording, video tape, book, or similar property," I.R.C. § 197(e)(4)(A) (1994), and "[a]ny interest in a patent or copyright," id. § 197(e)(4)(C). However, the provisions defining a "section 197 intangible" refer simply to "any franchise, trademark, or trade name," without distinguishing between ownership of the entire intangible and ownership of a partial interest in the intangible, such as a license (exclusive or nonexclusive). Id. § 197(d)(1)(F). A license to use a trademark is not ownership of the mark itself. However, it is possible that a license may itself be a "substantial portion" of a trade or business. See H.R. CONF. REP. No. 213, supra note 10, at 684, reprinted in 1993 U.S.C.C.A.N. at 1369. Section 197 does not define "acquisition" of a franchise, trademark, or trade name. The term might apply only to a true
provision is so sweeping that virtually no entertainment related property would be excluded.

Neither section 197 nor its legislative history addresses this problem. The statute expressly exempts “[a]ny interest in a film . . . or similar property” when it is “acquired separately.” However, the Conference Report appears to preclude “acquired separately” treatment for acquisitions that include any form of goodwill. If this interpretation accurately reflects congressional intent, then section 197 will apply to a wide variety of acquired intellectual property rights, especially in entertainment-related products. Indeed, many of these are acquired precisely because they have proven their market appeal—that is, because they include a substantial goodwill component. The goodwill component may generate substantial merchandising revenues. In some cases, the exhibition revenues generated by the property will still represent the most substantial part of its value, and the merchandising component will be incidental—for example, where a “name” performer appears in the picture, or the film contains distinctive and memorable features, such as fictional characters or locations—while in others, the merchandising revenues generated by the asset may represent a more significant component of the asset’s total revenue stream—for example, where particular characters (especially cartoon characters) are highly merchandisable.76

75. It would appear that the specific exception for “[a]ny interest in a film . . . or similar property” that is acquired separately, I.R.C. § 197(e)(4)(A) (1994) should override the more general provision governing trademarks, franchises, and trade names. Id. § 197(d)(1)(F). If not, then even in the case of a self-created film, the taxpayer would have to allocate a portion of the film’s production costs to the film’s trademarks and depreciate those costs under the § 197 rules.

76. In some cases, a taxpayer may acquire an entertainment-related product as much for its goodwill as for its creative or literary component. In such a case, the taxpayer appears to be acquiring an asset that consists largely of goodwill and/or trademarks, rather than property eligible for income forecast depreciation. Recall that merchandising income is entirely excluded from the income forecast calculation. See supra note 29. Where merchandising revenue is substantial, its exclusion from the formula may undermine the capacity of the income forecast method to match
By creating an exception for interests in individual films or similar copyright-based properties that are "acquired separately," Congress signaled an intent to preserve the income forecast method (or shorter recovery periods in general, as in the case where a taxpayer opts for the straight-line method but can demonstrate a useful life of less than fifteen years). Yet Congress has provided no guidance for determining which of these goodwill-containing properties should be treated as "acquired separately" and therefore exempt from section 197.77 If Congress indeed

income and expense. As discussed below, this problem might be resolved in a number of ways.

The first solution would be to differentiate between entertainment-related properties which are largely vehicles for goodwill (for example, films which are likely to produce merchandising revenues which are substantial in relation to their exhibition revenues) and properties which will generate most of their revenues through exploitation of their copyrights (for example, films likely to generate exhibition revenues far greater than their merchandising revenues). This distinction, however, could be difficult to apply in practice.

A second solution would be to amend § 197 to subject any interest in a copyright to 15-year straight-line depreciation. This would eliminate the need to distinguish between the goodwill and literary components of a motion picture, thus advancing the goal of simplification. In many if not most cases, this approach would do a poor job of matching income and expense. However, § 197 already has that effect on copyrights that are not "acquired separately," and the current rules necessitate a complex analysis whenever goodwill components are associated with a copyrighted work.

A third solution would be to change the income forecast calculation to treat merchandising income like exhibition income, thus requiring taxpayers to include projected merchandising income in the denominator, and actual merchandising income in the numerator. This solution would improve the accuracy of the income forecast method, thus strengthening the argument for excluding income forecast property such as motion pictures from § 197. This solution appears to exempt from § 197 an asset which is the equivalent of a trademark or goodwill. That result should not cause great concern, however, since unlike trademarks of the more traditional sort which typically have indefinite useful lives, the useful life of a film’s merchandisable components is likely to parallel fairly closely the useful life of the film’s copyright. In other words, during periods when a film is not being exhibited (and thus not producing any exhibition income), it is not likely to produce much merchandising income. What child wants a "Batman" lunch box when all her friends talk about is "The Lion King"? In some cases, a film’s embedded trademarks might outlast all of the copyrights in which they were embedded (including sequels, spin-offs, and other new works), but those cases would be the exception rather than the rule. Under this approach, there should be no need to allocate any portion of a film’s basis to its goodwill components and subject that basis to 15-year straight-line depreciation; the income forecast method should produce a clear reflection of income with respect to the entire basis.

77. The use of the term “franchise” in the House Conference Report language defining a “substantial portion” of a trade or business is itself problematic. Section 197(f)(4)(A) defines “franchise” by reference to § 1253(b)(1), where it is defined to include “an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.” I.R.C. § 1253(b)(1) (1994); H.R. CONF. REP. NO. 213, supra note 10, at 677, reprinted in 1993 U.S.C.C.A.N. at 1366; see Jefferson-Pilot Corp. v. Commissioner, 98 T.C. 435, 440-46 (1992) (discussing definition of “franchise” and applying the term to an FCC license), aff’d, 995 F.2d 530 (4th Cir. 1993). An interest in a film that is less than full ownership of the film’s copyright could easily constitute a “franchise” under this definition—typically, for
meant to exempt all individually-acquired motion pictures and similar properties, then section 197 will allow many taxpayers to subject lucrative trademarks to income forecast depreciation whenever those trademarks are embedded in a motion picture or other income forecast property. In most cases, this will allow taxpayers to depreciate the trademarks much more rapidly than the fifteen-year straight-line method would allow.

If embedded trademarks are exempt from section 197, while separately acquired trademarks are not, then the taxpayer acquiring the larger bundle of intangibles (the entire motion picture) is entitled to a more favorable depreciation method for the trademarks included in that bundle than the taxpayer acquiring a trademark by itself. For example, a taxpayer acquiring all rights to the film *The Lion King* would be able to subject the entire acquisition cost to income forecast depreciation, while a taxpayer acquiring only the right to merchandise the film’s “Simba” character would be treated as acquiring a trademark right, and thus could be required to depreciate that right under the fifteen-year straight-line method. Yet the second taxpayer has acquired only one right (which may exhaust the largest part of its income-generating potential within a few years), whereas the first taxpayer has acquired a much larger bundle of rights, one that merely includes the trademark right among many others. In most situations, the “acquired separately” provisions of section 197 offer the acquiring taxpayer more rapid depreciation of individually acquired assets. In the case of embedded trademarks, however, these provisions can lead to the opposite result.

The reason for this perverse result is that motion pictures, as well

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example, one party acquires the exclusive right to distribute the film or other entertainment product in a particular geographic area. Thus, the acquirer of the film rights in a particular geographic area might be unable to invoke the “acquired separately” provisions of § 197 to avoid the 15-year depreciation rule. It is not clear, however, whether Congress intended the same result where a license is not geographically limited—for example, where a party acquires a perpetual nonexclusive license, such as the right to use an actor’s name in promoting and exploiting a film, without geographic restrictions.

However, the legislative history of § 197 indicates that the exclusion for separately acquired interests in films, sound recordings, videotapes, books, and similar properties includes an interest as a licensee (including a right to broadcast or transmit a live event). H.R. CONF. REP. NO. 213, supra note 10, at 680, reprinted in 1993 U.S.C.C.A.N. at 1369. This suggests that Congress intended the term “franchise” to be narrowly construed in this context to exclude licenses in these entertainment-related products.

78. Even if the merchandising right were limited by contract to a period of less than 15 years, the presence of goodwill would probably place merchandising transactions beyond the scope of any regulatory exception for such short-term contracts. See supra note 63 and accompanying text.
as many other types of intellectual property (typically those related to
entertainment, and sometimes education), represent not a single asset but
a bundle of assets. In addition to the bundle of rights constituting a
copyright, such a work frequently includes rights in the nature of a
trademark. The embedded trademarks may already have acquired their
trademark character at the time the film is acquired, or else they may
acquire that character after the acquisition takes place, depending on
when they begin to perform an origin-identifying function. The origin-
identifying function of these embedded trademarks has a value separate
from the value of their function within the copyrighted work. However,
section 197 does not recognize that value. As a result, films and
similar works appear to qualify for the “acquired separately” exception
regardless of the merchandising potential of their embedded trademarks.
Thus, a taxpayer interested in merchandising a film’s trademarks for an
indefinite period of time would be well advised to frame the acquisition
as a license to use the motion picture itself rather than merely one of its
embedded trademarks.

A second ambiguity in section 197 comes into play whenever a
party acquires rights not in an individual motion picture or similar asset,
but in a larger grouping that includes at least one such asset—for
example, a television series, a film library, or a music publisher’s song
catalog. Not only is it more likely that such a transfer includes at least
one trademark, trade name, or other component of goodwill, but
according to the Conference Report, the larger the number of assets
transferred, the more likely they will be viewed as a substantial portion
of a trade or business even without finding the presence of a trademark,
trade name, or other goodwill component. Thus, virtually any transfer
of rights in multiple films or other copyrighted works, regardless of

79. The IRS itself drew this distinction in the 1979 memorandum in which it determined that
merchandising revenues should be excluded from the income forecast calculation because those
revenues were unrelated to the copyright interest acquired or produced by the taxpayer. There,
however, it concluded that none of a film’s production costs should be allocated to the film’s
Thus, whether the work is self-created or acquired, the presence of trademarks in a copyrighted work
is disregarded for depreciation purposes.

at 1367-68; supra notes 65-69 and accompanying text (discussing Conference Report definitions of
“substantial portion” and “trade or business” and the attachment of goodwill thereto). This problem
could arise even where a taxpayer acquires films that have not yet been released. Regardless of
whether any individual film contained indicia of goodwill, the group of films could be viewed either
as several discrete acquisitions (in which case the films would be “acquired separately”) or as a
substantial portion of the seller’s trade or business (in which case § 197 would apply).
whether they contain goodwill components, has the potential to force the purchaser to apply the fifteen-year straight-line method rather than the income forecast method, even if the latter would have been available had the assets been separately acquired.

These interpretive problems could also arise outside the copyright context. For example, a taxpayer might acquire the right to exploit a patented invention, together with the right to use a trademark or trade name associated with the invention. In some cases, it has been suggested that the acquisition of a patent right alone might constitute a substantial portion of a trade or business under section 197, even without the acquisition of a trademark or franchise.

These questions must be answered before section 197 can accomplish its simplification purpose. They do not appear susceptible to easy resolution. Rather than achieve its goal of eliminating controversy, the enactment of section 197 may simply shift the focus of the controversy from identifying the useful life of an acquired asset to determining whether it represents a substantial portion of a trade or business.

Even in cases where the transferred assets clearly constitute a substantial portion of a trade or business, the question remains whether it makes sense, from a policy perspective, to foreclose the income forecast method based on the manner of the acquisition. This rule has two distortive effects: First, it alters the total recovery period for any asset which reaches the end of its useful life well before or after the fifteen-year recovery period expires. Second, it allocates disproportionately small amounts of depreciation to time periods when an asset may be generating the largest portion of its revenue stream, and disproportionately large amounts of depreciation to time periods when an asset may generate little or no income.

The first objection applies equally to many assets which are ineligible for the income forecast method, since section 197 requires a taxpayer to use the fifteen-year straight-line method for many intangibles.

81. It could also supplant the shorter recovery period available under the straight-line method for assets with useful lives of less than 15 years.

82. See supra note 63 (discussing possible regulatory exclusion for separately acquired contracts fixed as to amount or enduring less than 15 years).

83. See Douglass, supra note 9, at 759-60.

84. For example, a motion picture may be released for a short period of time, then withheld from exhibition in order to build up demand for its re-release, which may take place in a later taxable year.
which have remaining useful lives of less than fifteen years.\textsuperscript{85} Congress was clearly aware of this effect when it enacted section 197.\textsuperscript{86} However, the second of these effects—shifting the timing of depreciation deductions within the recovery period—is largely limited to income forecast property, since most other intangibles would be depreciated under the straight-line method even if section 197 did not apply to them.\textsuperscript{87}

The background and legislative history of section 197, as well as the statutory language itself, indicate that interests in copyrights, patents, and other property for which the income forecast method is appropriate were not the target of that legislation. Rather, Congress enacted section 197 to end the longstanding controversy over the depreciability of certain types of acquired intangibles, the useful life of which was either unlimited or difficult to ascertain—notably, goodwill, going concern value, and certain intangibles closely related thereto, such as customer lists.\textsuperscript{88} Income forecast property had not historically generated controversy of this type.\textsuperscript{89} In fact, the exception for separately acquired interests in films, sound recordings, videotapes, books, or similar property was created in response to the film industry’s argument that, because the income forecast method applied to such creative property, the useful life question was simply irrelevant.\textsuperscript{90} Congress was simply not presented with any evidence that the income forecast method creates a significant risk that

\textsuperscript{85} For example, a three-year covenant not to compete would have a useful life of only three years, but still would be subject to the 15-year straight-line method. Similarly, a customer list might lose its value in less than 15 years.

\textsuperscript{86} In the case of a patent or copyright, the remaining useful life could be less than 15 years for any of several reasons: (1) the statutory term of the patent or copyright may be expiring; (2) the useful life of the patent or copyright may be shorter than its statutory term; or (3) the taxpayer may have acquired a license to use the property for a period of time shorter than its useful life or its statutory term.

\textsuperscript{87} \textit{See, e.g.}, House Hearings, supra note 10, at 35 (statement of Kenneth W. Gideon, Assistant Secretary of the Treasury for Tax Policy).

\textsuperscript{88} \textit{See, e.g.}, id. at 382-88 (statement of the Motion Picture Association of America, Inc.).

\textsuperscript{89} \textit{See supra} note 10 and accompanying text.

\textsuperscript{90} \textit{See} DESCRIPTION OF PROPOSALS, supra note 11, at 6-14 (collecting cases illustrating these controversies, none of which involved property which derived its value from patents or copyrights).

\textsuperscript{90} In hearings before the House Ways and Means Committee, Congressman Michael A. Andrews noted the industry’s concern that “the bill may cover the acquirer of film and film distribution rights even though those transactions are not part of the problem that H.R. 3035 is intended to correct.” House Hearings, supra note 10, at 86. The Treasury’s response was noncommittal: “[S]ome of the industry’s fears about the coverage of the bill are misplaced, while in other cases the industry has raised legitimate concerns.” Id. (response of Assistant Secretary of the Treasury for Tax Policy Kenneth W. Gideon to question from Congressman Andrews); see id. at 382-88 (statement of the Motion Picture Association of America, Inc.); Senate Hearings, supra note 63, at 169-73 (statement of the Motion Picture Association of America, Inc.).
the intangibles to which it applies will be depreciated over too short a period of time, because the useful life of such intangibles is based upon the income generated, not the passage of time.

However, the exception created by Congress for assets that are "acquired separately" does not go far enough and is not delineated clearly enough. The rulings authorizing the income forecast method repeatedly stress the importance of matching income and expense, and the appropriateness of the income forecast method in achieving that goal. Yet if section 197 is allowed to foreclose income forecast depreciation in situations where the latter method produces a clearer reflection of income, the goal of tax simplification will have been achieved at the expense of the matching principle.

The distortion introduced by section 197 is particularly acute when a taxpayer acquires a group of assets that includes some income forecast property which the taxpayer does not immediately exploit. This

91. See supra notes 30-41 and accompanying text. It may be that in some instances the income forecast method does not produce a clear reflection of income. For example, a taxpayer may deliberately underestimate an asset's future income stream in order to front-load depreciation deductions. However, the case law and rulings provide no evidence of such practices, and nothing in the legislative history of § 197 indicates that Congress was concerned about this possibility.

Any problems which impair the ability of the income forecast method to produce a clear reflection of income should be corrected by addressing the operation of the method itself—for all assets to which it applies—rather than by preserving the status quo for separately acquired assets and eliminating the method entirely for all others.

92. A 1991 study by the Congressional Research Service supports this assessment, and goes a step further, suggesting that any intangibles with non-expensable creation costs (thus excluding goodwill, for example) should be depreciated over their useful lives rather than subjected to the uniform depreciation method of § 197:

Despite assertions to the contrary, the choice of a uniform amortization period . . . turns out to provide the same effective tax rate for all intangibles, at least for assets purchased as part of an ongoing business. Neither economic efficiency nor tax equity require that separate amortization periods be ascribed to purchased intangibles depending on their degree of wasting away. The argument that tax lives should correspond to economic lives in this case has not been derived from a rigorous economic analysis, but rather has been based on reasoning by analogy with tangible assets. That reasoning is flawed because it does not take into account the expensing of created intangibles. Assets that deteriorate are replaced by new expenditures that are eligible for such expensing.

This analysis does not, however, apply to those intangible assets that are normally produced for sale (such as some computer software) or assets that are capitalized (such as movies). To properly measure income of these assets requires writing them off over their useful lives.

Gravelle & Taylor, supra note 12, at Summary (unpaginated); id. at CRS-2, CRS-7, CRS-12. The same report also implies that a uniform amortization period is not appropriate for assets that are capable of being sold separately from an ongoing business (in other words, assets clearly distinguishable from goodwill and going concern value). Id. at CRS-5, CRS-12.
commonly occurs, for example, where a taxpayer acquires a film library or music catalog, exploits some of the works immediately, but retains others for future use and decides not to exploit others at all (or at least not within the foreseeable future). If the taxpayer is treated as having acquired a substantial portion of a trade or business so that section 197 applies, then all of the acquired intangibles immediately become subject to mandatory fifteen-year straight-line depreciation. This front-loading of depreciation provides a windfall to the taxpayer with respect to any intangibles that are not being exploited during the current taxable period. In contrast, most taxpayers acquiring goodwill, customer lists, going concern value, and similar intangibles will be eager to exploit those assets quickly, before their revenue potential diminishes. A key difference between these intangibles and income forecast property is that a delay in exploiting the revenue potential of income forecast property does not necessarily coincide with a diminution in its value. In some cases, such as the re-release of a classic film after the owner has withheld it for several years in order to build up consumer demand, the revenue potential of the property may actually increase during the period of non-use.

In enacting section 197, Congress chose a broad-brush approach to the problem of depreciating intangibles. Yet Congress need not have adopted a uniform rule for all intangibles not “acquired separately.” Instead, it could have separated intangibles into classes, and treated each class differently according to its characteristics. Each class could have been assigned a predetermined useful life (as under section 168 for tangible property) or a particular methodology for determining its useful life—for example, the income forecast method, where appropriate. Goodwill and customer lists might have been placed in the same class, for example, if Congress wished to apply the same depreciation rules to both types of property. Property which a taxpayer elects to depreciate under the income forecast method could then have been placed in a separate class.

Although Congress considered other alternatives, it selected the
approach embodied in section 197 because it had the virtue of simplici-

ity. Without a doubt, simplicity is a laudable goal in any revision of the tax laws. However, eliminating income forecast depreciation for an otherwise eligible asset simply because some goodwill attaches (or might “under any circumstances” attach) to that asset, or to any other assets transferred in the same transaction, represents a “solution” that exceeds the scope of the problem.

There are three reasons why income forecast property could be excluded from section 197 without reintroducing undue complexity into the system. First, no useful life need be established for income forecast property, because the depreciation schedule is dictated by the actual income-generating performance of the property. Second, the categories of assets eligible for the income forecast method are clearly delineated by case law and rulings, and are not, in most cases, easily confused with intangibles that are non-income forecast property. Third, income forecast property can be more readily valued than the types of assets that

industry practice and experience for specific types of customer based, market share, and any similar intangible items, and regulations concerning the manner in which such intangible items may be valued separately and distinctly from other assets (including goodwill and going concern value).

DESCRIPTION OF PROPOSALS, supra note 11, at 29.

Another alternative Congress considered was to disallow all depreciation for customer base, market share, or similar intangibles lacking a determinate useful life, including:

- customer and subscription lists; patient or other records; the existing “core” deposits of banks; insurance in force in the case of an insurance company; advertising relationships and customer or circulation base in the case of a broadcast, cable, newspaper, cellular, or any other business; other contracts or relationships reflecting the value of the customer base; location advantage; workforce in place; and market share.

Id. Neither of these alternatives would have altered the pre-§ 197 rules for depreciating income forecast property such as patents and copyrights.

96. See House Hearings, supra note 10, at 29, 33 (statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy) Department of the Treasury); id. at 75-88 (statement of Jennie S. Stathis, Director for Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office) (discussing GAO proposal for multiple amortization periods for individually acquired assets); id. at 91, 93 (Testimony of Peter L. Faber on behalf of the American Bar Association); id. at 100, 101 (statement of Leonard Podolin, Chairman of the Tax Executive Committee of the American Institute of Certified Public Accountants); GAO REPORT, supra note 12, at 39.

97. Although some films may be acquired largely for their merchandising potential, see supra note 76 and accompanying text, this is as much an issue for separately acquired films as for films acquired in trade or business transaction, and it could be addressed by revising the income forecast formula as suggested in, supra, note 76.

98. Although, as discussed earlier, income forecast property can become imbued with goodwill as a result of its success in the marketplace, at the time it is created it is an asset distinct from goodwill and going concern value. See supra notes 76-79 and accompanying text.
have generated the most controversy—for example, customer lists, core deposits, and covenants not to compete—because there is normally an active market for income forecast property. Although there may inevitably be trademarks or other indicia of goodwill present in the creative work itself, income forecast property, such as patents and copyrights, is readily and frequently transferred from one party to another without transferring a substantial portion of any trade or business. In contrast, it is difficult to identify an income stream separately attributable to intangibles that are more closely intertwined with the ongoing operation of a business, such as customer lists and covenants not to compete. The significance of these differences between income forecast property and other section 197 intangibles is evidenced by the fact that none of the reported tax controversies which led Congress to adopt section 197 involved income forecast property.

V. CONCLUSION

In enacting section 197, Congress elevated tax simplification over the matching principle. However, the "acquired separately" exception undermines the simplification goal by reintroducing difficult line-drawing problems whenever multiple assets are acquired. In addition, even when a taxpayer acquires an individual intangible asset, in the case of many types of intellectual property, the actual or even potential presence of goodwill components in the bundle of rights acquired by the taxpayer may trigger section 197. Taxpayers currently have no clear guidelines for determining whether section 197 will apply in such situations. Either Congress or the Treasury should act quickly to provide the needed clarification.

One solution which Congress should consider is to remove income forecast property from the scope of section 197, regardless of whether the property is "acquired separately" within the meaning of the statute. That is, section 197 would not apply to any intangible which is eligible for income forecast depreciation, and which the acquiring taxpayer in fact depreciates under that method. Although under this approach it would once again be necessary to establish the value of the intangible, income forecast property is relatively easy to distinguish from other intangibles, and is easier to value than goodwill or its close equivalents such as

99. See supra note 92 (discussing a study that distinguishes goodwill and similar intangibles from those intangibles capable of being sold separately from an ongoing business).
trademarks and customer lists. The burden of conducting this valuation should also be weighed against the goal of producing a clear reflection of income, the very goal which has led the Treasury in the past to embrace the income forecast method.

100. In addition, § 197 does not entirely eliminate the need for separate valuations of acquired assets in the first place, since separate asset valuations will be necessary to establish an asset's cost basis if the buyer subsequently disposes of that asset. See I.R.C. § 1060(a).