Fifteen Years of Antichurning: It's Time to Make Butter

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Section 197 was enacted to reduce controversy between taxpayers and the IRS in connection with the amortization of certain intangible assets, including goodwill and going concern value. Although section 197 has largely served its purpose, the antichurning rules contained in section 197(f)(9) remain a source of much consternation for tax practitioners. The author argues that the antichurning rules have outlived their usefulness, and that to promote fairness and efficiency, the antichurning rules should be repealed. A previous version of this report was presented by the author to the members of the Tax Club in New York.

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I. Introduction

The intangible assets of a business, such as goodwill, going concern value, patents, and customer lists, often constitute a significant portion, if not most, of the value of an enterprise, as compared with its tangible assets such as property, plant, and equipment. When a purchaser acquires the assets of a business, the purchaser's ability to offset future taxable income generated by the business with depreciation or amortization deductions for U.S. federal income tax purposes can significantly affect the economics of the transaction; in other words, it can affect the price the purchaser is willing to pay for the business.

Before the enactment of the Revenue Reconciliation Act of 1993 (the RRA),[1] which added section 197, goodwill and going concern value were generally treated as nonamortizable intangible assets.[2] As a result, the portion of the purchase price of a business allocated to those assets could be used only to offset gain recognized on a future sale of the assets of the business.

Because of the less-than-optimal tax treatment of those intangibles, purchasers of businesses were often tempted to assign a proportionately greater amount of the purchase price of a business to depreciable tangible and amortizable intangible assets than to goodwill or going concern value. This often gave rise to conflicts between taxpayers, who attempted to allocate significant value to short-lived intangible assets similar to goodwill for which a useful life had been assigned and, accordingly, could be amortized, and the IRS, which claimed that a greater portion of the value should have been allocated to nonamortizable intangibles, such as going concern value.[3] The frequent litigation between taxpayers and the IRS, as amplified by the subjective nature of the valuation process generally and the significant amount of money at stake, was called one of the oldest controversies between taxpayers and the IRS by the General Accounting Office in its 1991 report to Congress on the taxation of intangibles.[4] Also, because depreciation deductions were allowed for the cost or other basis of intangible property used in a trade or business or held for the production of income only if the intangible property had a limited useful life that could be determined with reasonable accuracy,[5] questions about what constituted a limited useful life and reasonable accuracy abounded.

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[1]The RRA was enacted as part of the Omnibus Budget Reconciliation Act of 1993.

[2]Reg. section 1.167(a)-3, before amendment by T.D. 8865, 65 *Fed. Reg.* 3820 (Jan. 25, 2000), *Doc 2000-2456*, *2000 TNT 14-4*.

[3]It also resulted in protracted negotiations between purchasers of businesses, who wanted to allocate as large a portion of the purchase price of a business as reasonably possible to a seller covenant not to compete, which portion could be amortized over the term of the covenant, and sellers, who wanted to allocate as small a portion of the purchase price of a business to the covenant, because the portion of the purchase price allocable to a covenant not to compete was treated as ordinary income rather than capital gain.

[4]GGD-91-88, ''Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets'' (Aug. 9, 1991).

[5]Reg. section 1.167(a)-3, before amendment by T.D. 8865.

Legislation similar to that eventually enacted was first proposed on July 25, 1991, with the GAO report following shortly thereafter.[6] In 1992 the Supreme Court granted certiorari in *Newark Morning Ledger Co. v. United States*,[7] a case involving some of the relevant issues, and it issued its decision on April 20, 1993.[8] The taxpayer, Newark Morning Ledger Co. (as successor to the Herald Co.), was a newspaper publisher that had acquired eight newspapers and continued to publish them under their existing names.[9] The taxpayer allocated $67.8 million of the purchase price, an amount equal to the publisher's estimate of future profits to be derived from some identified subscribers (more than 450,000) to the eight newspapers as of the date of the merger, to an intangible asset it called ''paid subscribers.'' The subscribers' contracts were terminable at will by the subscribers and did not require advance subscription payments. The taxpayer claimed depreciation deductions for the paid subscribers on a straight-line basis over the estimated useful lives for average at-will subscribers of different types (which had been calculated using actuarial tables and various other statistical factors), and the IRS challenged those deductions.

In the litigation that ensued, the government argued that the asset ''paid subscribers'' was indistinguishable from goodwill, which was specifically prohibited from being depreciated by Treasury regulation section 1.167(a)-3, as in effect at the time. However, the government stipulated to the taxpayer's estimates of the useful life of the asset and did not contest the techniques used to calculate the taxpayer's estimate of the total value of the asset.[10]

A divided Supreme Court held 5 to 4 that if a taxpayer is able to prove with reasonable accuracy that an intangible asset that the taxpayer uses in a trade or business or holds for the production of income has a value that wastes over an ascertainable period of time, the taxpayer may depreciate the value of the asset over the asset's useful life regardless of how much the asset appears to reflect the expectancy of continued patronage. The Supreme Court cautioned that the taxpayer's burden of proof was substantial and would often prove too great to bear.[11] In this case, that the government had stipulated to the taxpayer's estimates and calculations seemed to play an important role in the decision.

In response, Congress enacted section 197,[12] in part because the ''severe backlog of cases in audit and litigation'' was ''a matter of great concern.''[13] Tax practitioners generally greeted the new section 197 with enthusiasm.[14] What practitioners may not have realized was that 15 years after enactment, they would still be spending significant time and energy grappling with the antiabuse provisions in section 197(f)(9) (the antichurning rules), which were intended to prevent taxpayers from converting a nonamortizable intangible into an amortizable section 197 intangible.[15] Experience seems to have proven section 197 to have been a success in reducing controversies between taxpayers and the IRS in this area. The author believes, however, that because the antichurning rules are complex, appear now to be unfair, result in transactions with almost identical economics having different tax consequences, and cause taxpayers to restructure their nontax-motivated business transactions to avoid the rules, the time has come for the repeal of the antichurning rules in section 197(f)(9).

II. Statutory and Regulatory Overview

Although section 197 was enacted in 1993, proposed regulations were not issued until early 1997[16] and were not finalized until January 2000.[17] Also, the final regulations issued in January 2000 included proposed regulations[18] that elaborated on specific issues related to partnerships, and those proposed regulations were finalized in November 2000.[19] Since then, there has been no significant guidance from the IRS or Treasury on these issues.[20]

A. Section 197 Generally

Section 197 permits taxpayers to amortize the adjusted basis of those intangible assets that constitute amortizable section 197 intangibles ratably over 15 years, beginning with the month in which they are acquired.[21]

Section 197 intangibles comprise the following: (1) goodwill; (2) going concern value; (3) workforce in place, including its composition and terms and conditions of its

[6]H.R. 3035, 137 *Cong. Rec*. E2706 (July 25, 1991); GGD-91-88, ''Tax Policy Proposals Regarding Tax Treatment of Intangible Assets'' (Aug. 9, 1991).

[7]*Cert. granted*, 503 U.S. 970 (Apr. 6, 1992).

[8]*Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993), *Doc 93-4810*, *93 TNT 87-1*.

[9]*Id.*

[10]*Id.*

[11]*Id.*

[12]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[13]Omnibus Budget Reconciliation Act of 1993, conference report on section 197, H.R. Rep. 213, 103d Cong., 1st Sess. 672-696 (1993).

[14]*See, e.g.*, New York State Bar Association (NYSBA) Tax Section, ''Report on Proposed Legislation on Amortization of Intangibles,'' *Tax Notes*, Nov. 25, 1991, p. 943. Section 197, as finally enacted, did not differ materially from the 1991 proposal.

[15]Omnibus Budget Reconciliation Act of 1993, Conference Report on section 197, H.R. Rep. 213, 103d Cong., 1st Sess. 672-696 (1993).

[16]Notice of Proposed Rulemaking (REG-209709-94), 62 *Fed. Reg*. 2336 (Jan. 16, 1997), *Doc 97-1565*, *97 TNT 14-15*.

[17]T.D. 8865, 65 *Fed. Reg*. 3820 (Jan. 25, 2000).

[18]Notice of Proposed Rulemaking (REG-100163-00), 65 *Fed. Reg*. 3903 (Jan. 25, 2000), *Doc 2000-2661*, *2000 TNT 20-68*.

[19]T.D. 8907, 65 *Fed. Reg*. 69667 (Nov. 20, 2000), *Doc 2000-29700*, *2000 TNT 224-3*. Also, T.D. 9257 (Apr. 7, 2006), *Doc 2006-6817*, *2006 TNT 68-7*, amended the rules applicable to some insurance contracts under section 197.

[20]*See, e.g.*, LTR 200724009 (Feb. 13, 2007), *Doc 2007-14269*, *2007 TNT 117-26*; LTR 200551018 (Sep. 15, 2005), *Doc 2005-25828*, *2005 TNT 247-18*; and Rev. Rul. 2004-49, 2004-1 C.B. 939, *Doc 2004-9500*, *2004 TNT 87-8*.

[21]Section 197(a).

employment; (4) business books and records, operating systems, or any other information base (including lists or other information regarding current or prospective customers); (5) any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item; (6) any customer-based intangible, meaning composition of market, market share, and any other value resulting from the future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers, and, in the case of a financial institution, deposit base and similar items; (7) any supplier-based intangible, meaning any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer; (8) any item similar to those listed in (3) through (7) above; (9) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof; (10) any covenant not to compete (or other arrangement to the extent it has substantially the same effect) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof; and (11) any franchise, trademark, or trade name.[22]

Intangibles specifically excluded from the definition of section 197 intangibles are: (1) any interest in a corporation, partnership, trust, or estate, or under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract; (2) any interest in land; (3) any computer software that is readily available for purchase by the public, is subject to a nonexclusive license, and has not been substantially modified, and other computer software that is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof; (4) any of the following items if not acquired in a transaction or series of related transactions involving the acquisition of assets constituting a trade or business or a substantial portion thereof: (a) any interest in a film, sound recording, videotape, book, or similar property; (b) any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof; (c) any interest in a patent or copyright; and (d) to the extent provided in reg. section 1.197-2(c)(13), any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if the right has a fixed duration of less than 15 years or is fixed as to amount and would otherwise be recoverable under a method similar to the unit-of-production method; (5) any interest under an existing lease or tangible property or any existing indebtedness (except as provided regarding financial institutions); (6) any right to service indebtedness that is secured by residential real property unless the right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than those rights) constituting a trade or business or substantial portion thereof; and (7) any fees for professional services and any other transaction costs incurred by parties to a transaction regarding which any portion of the gain or loss is not recognized under sections 351 through 368.[23]

To constitute an amortizable section 197 intangible, a section 197 intangible must have been acquired after August 10, 1993, the date of enactment of section 197, and must be held in connection with the conduct of a trade or business or an activity engaged in for the production of income.[24] Intangibles, other than (1) franchises, trademarks, or trade names; (2) covenants not to compete entered into in connection with an acquisition of an interest in a trade or business or a substantial portion thereof; and (3) licenses, permits, or other rights granted by a governmental unit or an agency or instrumentality thereof that are self-created rather than acquired will not constitute amortizable section 197 intangibles unless they are created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or a substantial portion thereof.[25]

If an asset constitutes an amortizable section 197 intangible, no other depreciation or amortization deduction is allowed with respect to it.[26] Thus, if a covenant not to compete constitutes an amortizable section 197 intangible, a taxpayer must amortize any portion of the purchase price of a business allocated to the covenant over 15 years, even if, under prior law, that amount would have been amortizable over the term of the covenant.[27]

Section 197(f) contains special rules that affect the applicability and operation of section 197. Among them is a rule that provides that if a section 197 intangible is acquired in a nonrecognition transaction under section 332 (complete liquidations of subsidiaries), section 351 (transfers to controlled corporations), section 361 (nonrecognition of gain or loss to corporations), section 721 (contributions to partnerships), section 731 (distributions from partnerships), section 1031 (like-kind exchanges), section 1033 (involuntary conversions), or in a transaction between members of an affiliated group that files a consolidated income tax return, the transferee steps into the shoes of the transferor for purposes of applying section 197 regarding the amount of the transferee's adjusted basis that does not exceed the transferor's adjusted basis in the section 197 intangible.[28] The Treasury secretary is authorized to issue regulations as may be

[22]Section 197(d).

[23]Section 197(e).

[24]Section 197(c)(1). Two transition rules permitted elections regarding the effective date. A retroactive election was available to apply the newly enacted section 197 to property acquired after July 25, 1991, and on or before August 10, 1993. Temp. reg. section 1.197-1T(c). A separate election was available to apply prior law to property acquired under a written, binding contract in effect on August 10, 1993, and at all times thereafter through the date of acquisition of the property. Temp. reg. section 1.197-1T(d).

[25]Section 197(c)(2); reg. section 1.197-2(d)(2)(iii).

[26]Section 197(b).

[27]*Id*.

[28]Section 197(f)(2); reg. section 1.197-2(g)(2).

appropriate to carry out the purposes of section 197, including to prevent the avoidance of section 197 through related persons or otherwise.[29]

B. The Antichurning Rules of Section 197(f)(9)

1. Generally. Section 197(f)(9) contains antichurning rules that exclude from the definition of amortizable section 197 intangible certain intangibles acquired in certain transactions. The conference report on section 197 states that those rules were enacted to ''prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under [prior] law into amortizable property.''[30] Those rules have been explained and expanded through statutorily authorized Treasury regulations, are extremely complex (with several cross-references), and, in the author's view, serve as an enduring and unnecessary trap for the unwary.

The antichurning rules apply to except from the definition of amortizable section 197 intangible any otherwise amortizable section 197 intangible for which depreciation and amortization deductions would not have been allowed under prior law,[31] including specifically goodwill and going concern value if (1) the intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 (the transition period),[32] by the taxpayer or a related person; (2) the taxpayer acquired the intangible from a person who held it during the transition period, and the user of the intangible does not change as part of the transaction; or (3) the taxpayer grants the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the transition period, but only if the transaction in which the taxpayer grants the right and the transaction in which the taxpayer acquired the intangible are part of a series of related transactions.[33]

2. Related person. The antichurning rules define ''related persons'' as any persons that are related under sections 267(b) or 707(b)(1), in each case applied by substituting 20 percent for 50 percent, and any persons that are engaged in trades or businesses under common control, within the meaning of section 41(f)(1)(A) and (B).[34]

a. Section 267(b). Section 267(b) defines ''related persons'' to include the following:

- members of a family, including only brothers and sisters (by whole or half blood), spouse, ancestors, and lineal descendants;
- an individual and a corporation, more than 20 percent of the value of the outstanding stock of which is owned directly or indirectly by or for that individual;
- two corporations that are members of the same controlled group under section 1563(a), with modifications;
- a grantor and a fiduciary of any trust;
- fiduciaries of different trusts, if the same person is the grantor of both trusts;
- a fiduciary of a trust and a beneficiary of such trust;
- a fiduciary of a trust and a beneficiary of another trust, if the same person is the grantor of both trusts;
- a fiduciary of a trust and a corporation, more than 20 percent of the value of the outstanding stock of which is owned directly or indirectly by or for that trust or the grantor of that trust;
- a person and an organization to which section 501 applies, and that is controlled, directly or indirectly, by that person or, if the person is an individual, by members of the person's family;
- a corporation and a partnership if the same persons own more than 20 percent of the value of the outstanding stock of the corporation and more than 20 percent of the capital or profits interests in the partnership;
- an S corporation and another S corporation, or an S corporation and a C corporation, if the same persons own more than 20 percent of the value of the outstanding stock of each corporation; and
- with some exceptions, an executor of an estate and a beneficiary of the estate.

Also, the following constructive ownership rules apply: (1) stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries; (2) an individual is considered as owning the stock owned, directly or indirectly, by or for the individual's family (which includes, for this purpose,

[29]Section 197(g).

[30]Omnibus Budget Reconciliation Act of 1993, conference report on section 197, H.R. Rep. 213, 103d Cong., 1st Sess. 672-696 (1993). Reg. section 1.197-2(h)(1)(ii) describes the purpose of the rules as being ''to prevent the amortization of section 197(f)(9) intangibles unless they are transferred after the applicable effective date in a transaction giving rise to a significant change in ownership or use.''

[31]Section 197(f)(9)(A). Deductions allowable under section 1253(d)(2) or under an election under section 1253(d)(3), both as in effect before the enactment of section 197, relating to acquisitions of franchises, trademarks, or trade names, and deductions allowable under reg. section 1.162-11, relating to certain improvements by a lessee on leased property, are treated as deductions allowable for amortization under prior law. Reg. section 1.197-2(h)(3).

[32]The transition period has been defined based on the dates legislation similar to section 197 was first introduced in Congress under H.R. 3035, 137 *Cong. Rec.* E2706 (July 25, 1991), and the date of enactment of section 197. If a valid retroactive election applying section 197 to assets acquired after July 25, 1991, was made under temp. reg. section 1.197-1T, the transition period is merely one day, July 25, 1991. Reg. section 1.197-2(h)(4).

[33]Section 197(f)(9)(A); reg. section 1.197-2(h)(2). If an entity owned or used a section 197 intangible at any time during the transition period, and the entity no longer exists, the entity is nevertheless deemed to exist for purposes of determining whether the taxpayer acquiring the intangible is related to the entity. Reg. section 1.197-2(h)(7).

[34]Section 197(f)(9)(C)(i).

only brothers and sisters, spouse, ancestors, and lineal descendants); and (3) an individual owning (otherwise than by the application of (2)) any stock of a corporation is considered as owning the stock owned, directly or indirectly, by or for the individual's partner (the partner stock attribution rule).[35] Stock constructively owned by reason of clause (1) of the preceding sentence is treated as actually owned by that person for purposes of applying the constructive ownership rules to treat another as the owner of the stock.[36]

b. Section 707(b)(1). Section 707(b)(1) defines "related persons" to include the following:

- a partnership and a person owning, directly or indirectly, more than 20 percent of the capital or profits interest in the partnership; or
- two partnerships in which the same persons own, directly or indirectly, more than 20 percent of the capital or profits interests.

The constructive ownership rules that apply for purposes of section 267(b), other than the partner stock attribution rule, also apply for purposes of section 707(b)(1).[37]

c. Common control.[38]

i. Controlled group of corporations. Section 41(f)(5) provides that the term "controlled group of corporations" has the meaning given to it by section 1563(a), with "more than 50 percent" substituted for "at least 80 percent" in section 1563(a)(1), without taking into account section 1563(a)(4) and (e)(3)(C). A controlled group of corporations includes any of three groups: a parent-subsidiary controlled group, a brother-sister controlled group, and a combined group.[39] A parent-subsidiary controlled group consists of one or more chains of corporations connected with a common parent corporation through stock ownership of at least 50 percent by vote or value, as long as the common parent owns at least 50 percent by vote or value of at least one of the other corporations, excluding from the calculation stock owned directly by any intermediary corporation.[40] A brother-sister controlled group consists of two or more corporations in which five or fewer persons who are individuals, estates, or trusts (1) own 80 percent or more by vote or value of each corporation; and (2) own more than 50 percent by vote or value of each corporation, taking into account each person's ownership only to the extent of their smallest holding in any of the brother-sister corporations.[41] A combined group consists of three or more corporations, each of which is a member of a parent-subsidiary controlled group or a brother-sister controlled group, and one of which is (1) a common parent corporation of a parent-subsidiary controlled group and (2) included in a brother-sister controlled group.[42] In making determinations regarding controlled groups of corporations, the excluded stock rules of section 1563(c) apply, which generally exclude nonvoting preferred stock and treasury stock.[43] Finally, constructive ownership rules may provide for attribution. For parent-subsidiary controlled groups, the following rules apply[44]:

- stock is treated as owned by a corporation if the corporation has an option to acquire the stock;
- stock is treated as owned by a partner that owns an interest of 5 percent or more (by capital or profits) in a partnership that owns the stock, to the extent of the partner's interest in the partnership; and
- stock owned by or for an estate or trust is treated as owned by any beneficiary who has an actuarial interest of 5 percent or more in the stock, to the extent of that actuarial interest; and stock owned by or for any portion of a grantor or other similar trust is treated as owned by the grantor.

For brother-sister controlled groups, the same rules apply, with the addition of the following rules[45]:

- stock owned by or for a corporation is treated as owned by any person who owns 5 percent or more in vote or value of the corporation, to the extent of that person's ownership interest;
- stock is treated as owned by an individual if the stock is owned by or for the individual's spouse, unless the spouse has unfettered control of disposition of the stock and the individual does not have any of various connections to the corporation;
- stock is treated as owned by an individual if the stock is owned by or for the individual's children who are under 21 years of age; and if the individual is under 21, any stock owned by the individual's parents is treated as owned by the individual; and
- if an individual owns more than 50 percent of the total combined vote or value of stock in a corporation, the individual is treated as owning the stock in that corporation owned by or for his parents, grandparents, grandchildren, and children who are at least 21 years of age.[46]

ii. Trades or businesses under common control. The term "trades or businesses under common control"

[35]Although a discussion of the constructive ownership rules of section 267(b) is beyond the scope of this article, it bears noting that given the proliferation of partnerships today, particularly in the context of alternative investing in private equity and hedge funds, many persons could, under the partner stock attribution rule, be treated as owning stock of other persons of which they are unaware.

[36]Section 267(c).

[37]Section 707(b)(3).

[38]Although section 197 refers to "common control" with a parenthetical cross-reference to section 41(f)(1)(A) and (B), only section 41(f)(1)(B) addresses the term "common control," whereas section 41(f)(1)(A) refers to a "controlled group of corporations." Because of the reference to both subparagraphs (A) and (B), it appears that both subparagraphs apply, but this is yet another instance of the difficulties inherent in the antichurning rules.

[39]Section 1563(a).

[40]Section 1563(a)(1), by operation of section 41(f)(5); temp. reg. section 1.1563-1T(a)(2); *see* temp. reg. section 1.1563-1T(a)(2)(ii), Example 4.

[41]Section 1563(a)(2); temp. reg. section 1.1563-1T(a)(3)(i),(ii).

[42]Section 1563(a)(3); temp. reg. section 1.1563-1T(a)(4).

[43]Section 1563(c)(1).

[44]Section 1563(d)(1).

[45]Section 1563(d)(2).

[46]For purposes of this section, children includes legally adopted children. Section 1563(e)(6)(C).

means any group of trades or businesses that is either a parent-subsidiary group under common control, a brother-sister group under common control, or a combined group under common control.[47] The rules refer to the term ''organization,'' which means a sole proprietorship, partnership, trust, estate, or corporation, and an organization may be a member of only one group of trades or businesses under common control.[48]

A parent-subsidiary group under common control consists of one or more chains of organizations that are connected through ownership of a controlling interest with a common parent organization, in which a controlling interest means more than 50 percent ownership by vote or value of a corporation or more than 50 percent of the capital or profits interest in a partnership, if (1) a controlling interest in each of the organizations, except the common parent organization, is owned by one or more of the other organizations; and (2) the common parent organization owns a controlling interest in at least one of the other organizations, excluding, in computing the controlling interest, any direct ownership interest by the other organizations.[49] The above calculations are made with options to acquire outstanding stock of a corporation treated as exercised.[50]

A brother-sister group under common control consists of two or more organizations if (1) the same five or fewer persons who are individuals, estates, or trusts own a controlling interest of each organization; and (2) those persons are in effective control of each organization, taking into account each person's ownership only to the extent of their smallest holding in any of the organizations.[51] ''Controlling interest'' for those purposes means more than 80 percent ownership by vote or value of a corporation or of the capital or profits interests in a partnership, and ''effective control'' means 50 percent ownership by vote or value of a corporation or of the capital or profits interests in a partnership.[52]

A combined group under common control consists of a group of three or more organizations in which (1) each organization is a member of either a parent-subsidiary group under common control or brother-sister group under common control, and (2) at least one organization is the common parent organization of a parent-subsidiary group under common control and also a member of a brother-sister group under common control.[53] In making determinations regarding trades or businesses under common control, both the excluded stock rules and constructive ownership rules similar to those detailed above for controlled groups of corporations apply.[54]

d. Timing of determination. The determination of whether persons are related is made both immediately before and immediately after the acquisition of the section 197 intangible.[55] In the case of a series of related transactions, or a series of transactions that together comprise a qualified stock purchase under section 338(d)(3), the determination is made immediately before the earliest transaction in the series of transactions and immediately after the last transaction in the series of transactions.[56]

e. De minimis rule. Two corporations are not treated as related for purposes of the antichurning rules if (1) they would be treated as related persons solely by substituting ''more than 20 percent'' for ''more than 50 percent'' in applying section 267(f)(1)(A), which defines the term ''controlled group''; and (2) each corporation possesses a beneficial ownership interest in the other's stock of less than 10 percent of the total vote and value of all shares outstanding.[57] For purposes of applying this rule, the constructive ownership rules of section 318(a) apply, but (1) in applying the attribution ''from corporations'' rule of section 318(a)(2)(C), the 50 percent limitation does not apply; and (2) in applying the attribution ''to corporations'' rule of section 318(a)(3)(C), 20 percent is substituted for 50 percent.[58]

f. Interaction with nonrecognition transactions. Although a transferee in a nonrecognition transaction would generally step into the shoes of the transferor for purposes of applying section 197, the antichurning rules prevent amortization of a section 197 intangible, even if it was amortizable in the hands of the transferor before the transaction, if immediately after the transaction (or series of transactions) in which the intangible was acquired, the transferee was related to any person who held or used the intangible during the transition period.[59]

3. Partnership rules. If there is an increase in the basis of partnership property under section 732, 734, or 743, for purposes of applying the ''related person'' rules, each partner is treated as having owned and used its proportionate share of the partnership's assets.[60] In those cases, the partnership is treated as an aggregate, rather than as an entity, for purposes of applying the antichurning rules. In all other partnership situations, the antichurning rules are generally applied at the partnership level, rather than at the partner level.[61]

a. Section 743(b). If a partnership interest is sold or transferred on death and the partnership has in effect an election under section 754 (a section 754 election) or one is made for the tax year in which the transfer occurs or the partnership has a substantial built-in loss immediately after the transfer, the basis of partnership property

[47]Reg. sections 1.41-6(a)(3)(ii) and 1.52-1(b).
[48]*Id*.
[49]Reg. section 1.52-1(c).
[50]Reg. sections 1.52-1(c)(1) and 1.414(c)-4(b)(1).
[51]Reg. section 1.52-1(d)(1).
[52]Reg. section 1.52-1(d)(2) and (3).
[53]Reg. section 1.52-1(e).
[54]*See* section 52(b); reg. sections 1.52-1(g) and 1.414(c)-3.

[55]Section 197(f)(9)(C)(ii).
[56]Reg. section 1.197-2(h)(6)(ii)(B) and -2(k), examples 24 and 25.
[57]Reg. section 1.197-2(h)(6)(iv)(A).
[58]Reg. section 1.197-2(h)(6)(iv)(B).
[59]Reg. section 1.197-2(h)(10).
[60]Section 197(f)(9)(E).
[61]Reg. section 1.197-2(h)(12)(i) (the commissioner has the discretion, under the partnership antiabuse rule in reg. section 1.701-2(e), to determine whether the partner level is more appropriate).

is adjusted with respect to the transferee.[62] The antichurning rules apply to those basis adjustments only if the transferee is related to the transferor, and they do not apply based on the transferee's relationship to the partnership or other partners.[63]

Also, in accordance with the exception to the antichurning rules for transfers on death in which basis is determined under section 1014 (discussed further below), the antichurning rules do not apply when a section 743(b) basis adjustment is made by reason of the death of a partner, with the new partner's basis determined under section 1014(a). In that situation, the new partner is treated for purposes of the antichurning rules as acquiring the interest from an unrelated person.[64]

b. Section 732(d). Section 732(d) permits a partner that receives a distribution of property other than money within two years of the partner's acquisition of the partnership interest from a partnership that did not have in effect a section 754 election at the time of the distribution to elect to treat the basis of that property as it would have been treated had the section 754 election been in effect.[65] For purposes of the antichurning rules, adjustments under section 732(d) are analyzed as if the section 754 election had been in effect at the time of the acquisition of the partnership interest.[66]

c. Section 732(b). On a partnership's distribution of property to a partner in liquidation of the partner's interest in the partnership, the partner's basis in the property other than money distributed to the partner is equal to the partner's basis in its partnership interest (less any money received in the liquidating distribution).[67] In accordance with the approach of treating each partner as owning and using its share of partnership intangibles, a liquidating distribution that includes an intangible is analyzed under the antichurning rules as if it were a transfer directly between partners — that is, the distributee partner is treated as receiving both its own share of the intangible and the share of each of the other partners. An increase in the basis of the distributed intangible is amortizable to the extent it does not exceed the other unrelated partners' shares of unrealized appreciation.[68] The share attributable to the distributee partner (or any partner related to the distributee partner) may nonetheless be amortizable if that partner's interest was ''cleansed'' by acquisition in a transaction that was not subject to the antichurning rules.[69]

Despite application of the above rules, the antichurning rules may nevertheless continue to apply on a subsequent transfer of the intangible if the total unrealized appreciation of the intangible exceeds the section 732(b) basis adjustment at the time of the distribution (or if a portion of the intangible was otherwise not amortizable in the hands of the distributee).[70]

d. Section 734(b). If partnership property is distributed to a partner and the partnership has in effect a section 754 election or one is made for the tax year in which the transfer occurs, or there is a substantial basis reduction with respect to the distribution, the basis of the partnership in its assets is adjusted to reflect the recognition of gain or loss by the distributee partner.[71] For purposes of the antichurning rules, when a section 734(b) adjustment applies to an intangible asset held by a partnership, the transaction is analyzed as if each continuing partner acquired an interest in the intangible from the distributee partner.[72] Provided the continuing partner is not the distributee partner or related to the distributee partner, the antichurning rules will not apply to the continuing partner's share of any increase in basis in the intangible.[73] The continuing partner's share of the increase in basis may also be amortizable if that partner's interest was ''cleansed'' by acquisition in a transaction that was not subject to the antichurning rules.[74]

e. Antiabuse rule. The special rules applicable to partnership basis adjustments contain their own antiabuse rule, which is intended to prevent taxpayers from circumventing the antichurning rules by transferring title without a corresponding change in the user of the intangible.[75] If an ''antichurning partner'' or a related person (other than the partnership) becomes or remains a direct user of the intangible that is treated as transferred, then the antichurning rules apply to deny amortization to the extent that the antichurning partner is treated as having transferred the intangible.[76] An antichurning partner means (1) regarding all intangibles held by a

[62]Section 743(b). A partnership has a substantial built-in loss regarding a transfer of property if the excess of (1) the partnership's adjusted basis in partnership property immediately after the transfer over (2) the fair market value of the partnership property is greater than $250,000. Section 743(d).

[63]Reg. section 1.197-2(h)(12)(v).

[64]Reg. section 1.197-2(h)(12)(viii).

[65]Section 732(d). Also, the basis adjustment rules of section 732(d) will apply to a partner (regardless of whether an election has been made) if, at the time of the partner's acquisition of the partnership interest, (1) the fair market value of all partnership property other than money exceeded 110 percent of its adjusted basis to the partnership; (2) an allocation of basis under section 732(c) on a liquidation of the partner's interest immediately after the acquisition would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance; and (3) a basis adjustment under section 743(b) would change the basis to the partner of the property actually distributed. Reg. section 1.732-1(d)(4).

[66]Reg. section 1.197-2(h)(12)(iii).

[67]Section 732(b).

[68]Reg. section 1.197-2(h)(12)(ii).

[69]*Id*.

[70]Reg. section 1.197-2(h)(12)(ii)(C).

[71]Section 734(a) and (b). A substantial basis reduction exists if the sum of (1) the amount of any loss recognized by the distributee partner regarding the distribution under section 731(a)(2); and (2) for any distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee partner (determined under section 732) over the adjusted basis of the distributed property to the partnership immediately before that distribution (as adjusted by section 732(d)) exceeds $250,000. Section 734(d).

[72]Reg. section 1.197-2(h)(12)(iv).

[73]*Id*.

[74]*Id*.

[75]Reg. section 1.197-2(h)(12)(vi).

[76]Reg. section 1.197-2(h)(12)(vi)(A).

partnership on or before August 10, 1993, any partner to the extent that (a) the partner acquired its interest in the partnership on or before August 10, 1993, or (b) the partner's interest was acquired from a person related to the partner on or after August 10, 1993, and that interest was not held by any person other than persons related to the partner at any time after August 10, 1993; or (2) regarding any section 197 intangible acquired by the partnership after August 10, 1993, that is not amortizable with respect to the partnership, any partner to the extent that (a) the partner's interest in the partnership was acquired on or before the date the partnership acquired the section 197 intangible, or (b) the partner's interest was acquired from a person related to the partner on or after the date the partnership acquired the section 197 intangible and that interest was not held by any person other than persons related to the partner at any time after the date the partnership acquired the section 197 intangible.[77]

f. Section 704(c) allocations. If a partner contributes property to a partnership and its tax basis differs from its book value, the disparity must be borne by the contributing partner and not shifted to any other partner.[78] The regulations under section 704 provide three methods for accomplishing this goal (although other methods may be acceptable): the traditional method, the traditional method with curative allocations, and the remedial allocation method.[79] If a partner contributes an asset (to which the section 704(c) allocation rules apply) that was an amortizable section 197 intangible in its hands to a partnership, the partnership may generally use any of the allocation methods provided in section 704(c) with respect to the intangible, and the antichurning rules will not apply.[80] If, however, a partner contributes a section 197 intangible that was not an amortizable section 197 intangible in its hands to a partnership, a noncontributing partner may receive only remedial allocations of amortization regarding the intangible, and only if (1) the noncontributing partner is not related to the partner that contributed the intangible; and (2) as part of a series of related transactions that includes the contribution of the section 197 intangible to the partnership, the contributing partner or a related person (other than the partnership) does not become or remain a direct user of the contributed intangible.[81]

4. Exceptions. The antichurning rules do not apply to acquisitions of section 197 intangibles by reason of death when basis is increased under section 1014(a).[82] Also, the antichurning rules do not apply if the intangible was an amortizable section 197 intangible in the hands of the transferor before an acquisition, and the acquisition and the transaction in which the transferor acquired the intangible are not part of a series of related transactions.[83]

If the antichurning rules would otherwise apply to an acquisition, those rules will not apply if (1) the buyer would not be related to the seller but for the substitution of 20 percent for 50 percent in the related person rules; (2) the seller elects to recognize gain on the sale of the section 197 intangible; and (3) the seller, regardless of whether it is otherwise subject to tax, pays federal income tax on the gain at the highest rate imposed by section 1 (for noncorporate taxpayers) or section 11 (for corporations and tax-exempt entities).[84] The antichurning rules will apply to the extent that the buyer's basis in the intangible exceeds the seller's recognized gain.[85]

Finally, the antichurning rules will not apply when an election is made under section 338 to treat a stock purchase as an asset purchase for U.S. federal income tax purposes, provided the new corporation deemed to have been created as a result of the election is not otherwise treated as related to the acquired corporation.[86]

5. The general antiabuse rule. A section 197 intangible that would otherwise qualify for amortization under section 197 will not qualify if one of the principal purposes of the transaction in which it is acquired is to avoid the requirement that the intangible be acquired after August 10, 1993, or to avoid the operation of the antichurning rules.[87] A transaction will be presumed to have such a prohibited purpose if the acquisition does not effect a significant change in the ownership or use of the intangible.[88] For example, if a section 197 intangible is acquired in a transaction (or series of related transactions) in which an option to acquire stock is issued to a party to the transaction, but the option does not trigger related person status under the antichurning rules, the antiabuse rule may apply.[89]

III. Practicality and Fairness

Recently, issues regarding the amortization of basis increases in goodwill have arisen in connection with transactions in which investment management, private equity, or hedge fund firms have engaged in initial public offerings (IPOs). Some of those entities were, before their IPOs, classified as partnerships for U.S. federal income tax purposes, but used a corporate entity to go public, using an umbrella partnership real estate investment trust (UPREIT), or UP-C, structure.[90] A new C corporation would be created. That C corporation would sell shares to the public, and the cash raised by the C corporation would be used to purchase interests in the partnership from the existing owners. The partnership

[77]Reg. section 1.197-2(h)(12)(vi)(B). All references above to August 10, 1993, are treated as references to July 25, 1991, if the relevant party made a valid retroactive election under temp. reg. section 1.197-1T. Reg. section 1.197-2(h)(12)(vi)(C).

[78]Section 704(c).

[79]Reg. section 1.704-3.

[80]Reg. section 1.197-2(h)(12)(vii)(A).

[81]Reg. section 1.197-2(h)(12)(vii)(B).

[82]Section 197(f)(9)(D); reg. section 1.197-2(h)(5)(i). *See, e.g.*, LTR 199949037 (Sept. 1, 1999), *Doc 1999-38767*, *1999 TNT 238-17*.

[83]Reg. section 1.197-2(h)(5)(ii).

[84]Section 197(f)(9)(B); reg. section 1.197-2(h)(9).

[85]Reg. section 1.197-2(h)(9)(ii).

[86]Reg. section 1.197-2(h)(8) and -2(k), Example 23.

[87]Section 197(f)(9)(F).

[88]Reg. section 1.197-2(h)(11).

[89]*Id.*

[90]*See, e.g.*, Pzena Investment Management Inc., SEC Form S-1, filed June 11, 2007; Evercore Partners Inc., SEC Form S-1, filed May 12, 2006.

would make a section 754 election for the year of the sale (if it did not already have one in place), and the C corporation would obtain a basis step-up for the portion of the assets of the partnership that it was treated as acquiring. The existing partners would also have the right, over time, to exchange their interests in the partnership for interests in the C corporation so that they could obtain liquidity. Those later exchanges of partnership interests for stock in the C corporation would be taxable transactions for U.S. federal income tax purposes.

Most of the value attributable to those types of businesses is goodwill, such that the basis step-up to the C corporation was primarily reflected in a section 197 intangible, and the amortization deductions associated with that basis increase would have significant value. Because the investment bankers believed the public would not pay for the value of the amortization deductions through a higher price per share on the IPO, the C corporation would enter into a tax receivables agreement with the selling partners under which the C corporation would be required to pay 85 percent of the tax benefit provided by the amortization deductions arising from the initial sale of partnership interests to the C corporation and from future taxable conversions of partnership interests to stock of the C corporation by the sellers of the partnership interests. Those payments would be treated as additional purchase price regarding the partnership interests, and because they were made after the year in which the sale or exchange occurred, a portion of each payment would be treated as interest. The portion of each additional payment that was treated as additional purchase price would further increase the basis in the intangible.[91] Because of the significant value attached to these amortization deductions, it was necessary to ensure that in the case of a business that existed on or before August 10, 1993, the antichurning rules did not apply. Those IPOs were done to provide liquidity to the existing partners, to create a publicly traded security that the business could use to compensate its employees, and, in the case of IPOs that were primary offerings rather than secondary sales, to raise capital for the business. None of those IPOs were undertaken with a principal purpose of converting existing goodwill into an amortizable asset. Those IPOs would have been undertaken even if the amortization deductions associated with the increase in the basis of the goodwill were not available.[92]

In those situations, because the basis increase arose under section 743, the antichurning analysis was applied to determine whether the C corporation was related to any of the continuing partners in the partnership.[93] Because the ownership structure of the partnership might itself have been complex with partnership interests held by upper-tier partnerships and overlapping ownership among those partnerships, the application of the related person rules, with their inherent complexity and all of their cross-references and modifications, became daunting. Although tax practitioners generally do not shy away from applying complex rules,[94] the time and effort expended in navigating those rules is not well-spent given that the antichurning rules themselves are, from a policy perspective, no longer necessary. The antichurning rules apply to intangible assets that were held by the taxpayer on or before August 10, 1993 (and on or after July 25, 1991). Over time, it is likely that the value of any such intangible asset has changed significantly, whether increasing or decreasing. It would seem unlikely, although not impossible, that taxpayers would engage in sales of businesses to related persons to achieve an amortizable increase in the basis of their intangible assets rather than for valid business reasons, as was the case in the IPOs described above.[95]

Also, the antichurning rules can apply only to businesses that existed on August 10, 1993. If a business was started on or before August 10, 1993, such that a section 197 intangible had already been created by August 10, 1993, the antichurning rules could apply at any point in the future; whereas if the same business was started on August 11, 1993, the antichurning rules could never apply. This potentially disparate treatment of entities created at different times now appears capricious and unfair.

Finally, if the antichurning rules were to apply to prevent a section 197 intangible from being an amortizable section 197 intangible, the rules would apply not only to prevent the amortization of the value of intangible assets subject to the antichurning rules as of August 10, 1993, but to all of the increase in value of the intangible assets since then. This result is also unfair,

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[91]To reflect the additional basis, the adjusted basis of the intangible is increased as of the beginning of the month of the addition, and the additional amount, if amortizable, is amortized ratably over the remaining months in the original 15-year period. Reg. section 1.197-2(f)(2)(i). Legislation was proposed, but not enacted, in 2007 that would have caused any gain recognized by the sellers to be treated as ordinary income rather than capital gain for transactions in which there existed a tax receivables agreement. H.R. 3996, 110th Cong. (1st Sess. 2007).

[92]The UP-C structure described above, in which the existing partners retained their interests in the original partnership rather than converting their partnership interests to corporate stock in a nonrecognition transaction under section 351 at the time of the creation of the C corporation, provided the following tax benefits to the existing partners: (1) income earned by the business that was characterized as capital gain rather than ordinary income would flow through to the partners and be taxed at the lower rates applicable to capital gains; (2) the partners' bases in their partnership interests would increase as income of the partnership was allocated to them, thereby reducing gain on a future exchange of interests for stock; and (3) in the case of a dividend-paying stock, a second level of tax could be avoided if the distributions from the operating partnership were made directly to the partners in the partnership rather than having to pass through a C corporation.

(Footnote continued in next column.)

[93]Section 197(f)(9)(E).

[94]This is, of course, how they make their money.

[95]Although the author believes that the antichurning rules of section 197(f)(9) should be repealed, to the extent that there are still lingering concerns of abuse, the antichurning rules could be converted into a purely antiabuse rule, in which the determination of whether a "churned" intangible should be amortizable is made on a case-by-case basis.

given that fledgling businesses in 1993 may have grown to multimillion-dollar enterprises over the past 15 years.[96]

IV. Same Economics, Different Tax Consequences

Since the early 1990s, when it started becoming widespread for states to adopt limited liability company statutes,[97] the check-the-box regulations were promulgated,[98] and some aspects of the U.S. federal income tax treatment of single-member and multiple-member LLCs in Rev. Rul. 99-5[99] and Rev. Rul. 99-6 were clarified,[100] the use of LLCs to operate privately held businesses has proliferated. An LLC is classified, for U.S. federal income tax purposes, as either (1) an entity disregarded from its owner (a disregarded entity) if it has a single member or (2) as a partnership if it has more than one member.[101] Operating as an LLC is desirable because an LLC provides the limited liability of a corporation, avoids the double taxation associated with C corporations, and provides more flexibility in terms of the ability to divide the economics among its equity owners than an S corporation, which can have only one class of stock.[102] An LLC also enables its owners to deliver a basis step-up in the assets of the LLC when interests in the LLC are sold.

For an LLC that is treated as a disregarded entity, a taxable acquisition of an interest in the LLC is treated as an asset purchase,[103] and for an LLC that is classified as a partnership, a taxable acquisition of an interest in the LLC from another member will provide a basis adjustment under section 743(b) if the LLC has in effect, or makes for the tax year in which the acquisition occurs, a section 754 election. The ability to deliver a step-up in the basis of its assets to a buyer can have major pricing implications in the context of a sale of a business. Not only is the buyer potentially able to amortize the higher basis in the tangible assets, but under section 197, to the extent that a portion of the purchase price is allocable to goodwill or going concern value,[104] the purchaser would generally expect to be able to amortize that amount on a straight-line basis over 15 years. In many cases, most of the value of a business is allocated to goodwill or going concern value.[105] The value of those amortization deductions in reducing the U.S. federal income tax liability of the new owners of the business can therefore significantly increase the price a purchaser would be willing to pay for the business. Because of this significant value, the ability to amortize the goodwill or going concern value has become an issue in many acquisitions, in which it is important to ensure that the antichurning rules of section 197(f)(9) do not apply to an acquisition for the purchaser to get the value for which it has bargained.

As discussed above, the antichurning rules are generally designed to prevent the amortization of goodwill when it would not otherwise be amortizable through sales to related parties, and provide complicated rules for determining when this has occurred. The rules, however, with their focus on form, are overbroad and prevent the amortization of goodwill following bona fide third-party purchases of businesses, rather than just serving the legitimate purpose of preventing tax avoidance.

This is best illustrated by an example that shows how one can achieve different results in two transactions that are almost identical from an economic perspective, with the antichurning rules seeming to constitute a trap for the unwary or unlucky. In the first situation, a woman started a business in 1990 that she operated as a sole proprietorship and that she contributed to a single-member LLC in 2000. When her son graduated from medical school in 2004, she transferred to him as a gift a 1 percent interest in the LLC, even though she was disappointed that he would not be joining the business.[106] All of the income, gain, loss, and deductions of the LLC were shared by the mother and the son in the ratio of 99 to 1. In 2006 an unrelated private equity (PE) fund wanted to buy the business, but wanted the mother to retain a 25 percent equity stake in the business because she would continue to operate the business after the acquisition. Accordingly, the PE fund purchased the son's entire interest in the LLC and an additional 74 percent of the equity of the LLC from the mother.

Assuming that the LLC had in effect, or made for the year of the acquisition, a section 754 election, the PE fund should be entitled to a basis step-up in the portion of the assets of the LLC attributable to its ownership interest in the LLC under section 743(b) that it would then seek to amortize or depreciate to offset the future taxable income generated by the LLC.[107] Because a portion of the assets being acquired constitutes goodwill, it is necessary to

[96]The proof of this is that some of the businesses engaging in those IPOs were small enterprises in 1993, while other businesses engaging in those IPOs did not even exist then. All of those entities are today valued in the many millions of dollars.

[97]Wyoming first enacted an LLC statute in 1977, followed by Florida in 1982, but no other states enacted the statutes until after the IRS issued Rev. Rul. 88-76, 1988-2 C.B. 360, clarifying that LLCs would be treated as partnerships for U.S. federal income tax purposes. 1977 Wyo. Sess. Laws 512; Fla. Stat. Ann. sections 608.401 to -471. In a matter of a few years, all 50 states had enacted them, ending with Hawaii in 1996. Haw. Rev. Stat. Ann. sections 428-101 to -1302.

[98]Reg. section 301.7701-3.

[99]Rev. Rul. 99-5, 1999-1 C.B. 434, *Doc 1999-2045*, *1999 TNT 10-6*.

[100]Rev. Rul. 99-6, 1999-1 C.B. 432, *Doc 1999-2092*, *1999 TNT 10-7*.

[101]Such a classification assumes that no check-the-box election has been made to treat the LLC as a corporation for U.S. federal income tax purposes. This assumption applies to the discussion of LLCs throughout this article.

[102]Section 1361(b)(1)(D).

[103]*Supra* note 99.

[104]Reg. sections 1.1060-1(a)(1) and 1.338-6. Goodwill and going concern value are Class VII assets.

[105]References to goodwill in the remainder of this report include "going concern value."

[106]The woman paid all applicable gift taxes on the transfer.

[107]A more common structure would be for the PE fund to use debt to acquire a portion of the interests, that is, the LLC would borrow money that would be distributed to the mother and the son in connection with the acquisition, instead of using 100 percent equity. This, however, creates additional complications

(Footnote continued on next page.)

ensure that the antichurning rules do not prevent the amortization of the goodwill. The general rule in section 197(f)(9) provides that the goodwill will not be treated as an amortizable section 197 intangible if "the intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person." Under this general rule, the PE fund would be the taxpayer, and under the related person rule of section 707(b)(1), the LLC would be treated as a related person regarding the PE fund because the PE fund owns more than 20 percent of the capital and profits interests in the LLC, so that the antichurning rules would normally apply to the acquisition. However, the special rule applicable to increases in the basis of partnership property under section 743 contained in section 197(f)(9)(E), which provides that determinations are made at the partner level and each partner is treated as having owned and used that partner's proportionate share of the partnership assets, applies. As a result, it is the relationship between the "taxpayer," that is, the PE fund, and the mother that must be tested. Because the mother is not related to the PE fund, the antichurning rules do not apply.

The facts of the second situation are the same as in the first except that in 2003, the PE fund approached the woman regarding a potential acquisition of the business. The woman owned all of the interests in the LLC because although she intended to gift to her son a 1 percent interest in the LLC on his graduation from medical school, he had not yet graduated. In this case, the PE fund purchased from the mother 75 percent of the interests in the LLC. Under Rev. Rul. 99-5, the purchase is treated as an acquisition by the PE fund of a 75 percent undivided interest in each of the assets of the LLC, followed by a contribution to a newly formed partnership of a 25 percent interest in each of the assets of the LLC by the mother (with no stepped-up basis) and a contribution of a 75 percent interest in each of the assets of the LLC by the PE fund (with a stepped-up basis) under section 721. In this situation, because the PE fund's basis step-up did not arise under section 732, 734, or 743, the PE fund cannot rely on section 197(f)(9)(E) to avoid the antichurning rules. Under section 197(f)(2) and reg. section 1.197-2(g)(2), because the partnership acquired the section 197 intangible from a person in whose hands it was an amortizable asset in a transaction governed by section 721, the section 197 intangible contributed by the PE fund to the LLC should be amortizable by the LLC.

Reg. section 1.197-2(h)(10) and -2(k), Example 18, however, conclude that the antichurning rules apply not only to the portion of the intangible deemed contributed to the partnership by the mother, but also to the portion of the intangible deemed contributed to the partnership by the PE fund. Although the original deemed purchase of the assets was by a party (the PE fund) unrelated to the seller (the mother) such that the antichurning rules should not literally apply, at the end of the series of transactions that are deemed to occur under Rev. Rul. 99-5, the result reached is identical to that in section 197(f)(9)(A)(i), because the mother held the assets during the transition period and the mother and the partnership are related persons.[108]

This rule and the example in the regulations follow almost exactly the suggestion in the New York State Bar Association (NYSBA) Tax Section's "Report on Issues to Be Addressed in Regulations Under Section 197."[109] The NYSBA report offered this fact pattern and concluded that the result under the statute — whether section 197(f)(9)(A)(i) should trump section 197(f)(2) — was unclear. Nevertheless, the NYSBA report suggested that for purposes of simplicity, the antichurning rules should apply, even though up to 80 percent of the deductions may be allocable to the new partner, because it would otherwise complicate the capital account maintenance rules if amortization were permitted for the new partner's share of the intangible but not for the continuing partner's share of the intangible. Despite the "simplicity" of the approach, the result, given the almost identical fact patterns and economics in the two situations described above — which are different only because of the timing of the PE fund's purchase relative to the son's graduation from medical school — seems patently unfair.[110]

One potential solution would be for a taxpayer to use a self-help mechanism in which the taxpayer would sell or transfer a portion of the LLC interest to form a new partnership before a sale to a third party. Given the form-driven nature of the antichurning rules, one would think this should be permissible. The NYSBA report discussed this type of situation as well — the creation of a partnership before a sale to a third party of an interest in the partnership for cash. The NYSBA report said the

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regarding basis adjustments under section 734(b), which are not necessary to discuss for purposes of the argument here.

[108]Although the application of the rules is form-driven, the conclusion reached in the regulations is based on a substance-over-form step transaction approach. In contrast, if one acquires a section 197 intangible that was an amortizable section 197 intangible in the hands of the seller, and the transaction in which the intangible is acquired and the transaction in which the seller acquired the intangible are not part of a series of related transactions, the antichurning rules do not apply to the acquisition of the intangible, even if the acquirer is related to the party that sold the intangible to the seller. Reg. section 1.197-2(h)(5)(ii).

[109]The difference between the fact pattern in the NYSBA report and the example in the regulations is that the NYSBA report says that the parties "previously contemplated" the drop-down at the time of the asset sale, and the regulation says that the drop-down occurred "immediately after" the asset purchase. One can assume that if the drop-down occurred immediately after the asset purchase, then it was contemplated at the time of the asset purchase. NYSBA, "Report on Issues to Be Addressed in Regulations Under Section 197" (Jan. 19, 1995), *Doc 95-724*, *95 TNT 12-20*; reg. section 1.197-2(k), Example 18.

[110]A question to ponder is whether the NYSBA report would have reached a different conclusion on this issue had the check-the-box regulations and Rev. Rul. 99-5, 1999-1 C.B. 434, already been issued, and the fact pattern described above become commonplace, when the NYSBA report was drafted. One with a revenue-raising mindset could, of course, argue that this disparate treatment could also be eliminated through the repeal of the generally taxpayer-favorable rule in section 197(f)(9)(E).

choice of form should not implicate the antichurning rules, even though the result was the same as under the facts referenced in section 197(f)(9)(A)(i) and the situation in which there is a disguised sale to a partnership. The NYSBA report recommended, and Example 17 of reg. section 1.197-2(k) ultimately confirmed, that the antichurning rules apply. The regulations under section 197 adopted the proposal of the NYSBA report in modified form. Reg. section 1.197-2(k), Example 19, provides that if a taxpayer forms a partnership with an affiliate and ''in a subsequent year, in a transaction that is properly characterized as a sale of a partnership for Federal income tax purposes,'' sells an interest in the partnership to a third party (and the partnership has in effect a section 754 election or one is made for the tax year in which the purchase of the partnership interest occurs), the third-party purchaser may amortize the basis increase in a section 197 intangible held by the partnership. It is left for the taxpayer to determine whether the step transaction doctrine might apply to conclude that the sale is not properly characterized as a sale of a partnership interest for U.S. federal income tax purposes in a situation in which the partnership was formed in contemplation of the sale. Also, the example in the regulations states that the sale of the partnership interest to a third party occurred in a year after the year in which the partnership was formed, suggesting that some time may need to pass between the formation of the partnership and the sale of the partnership interest to rely on the favorable conclusion reached in the example. The description of the fact pattern in the example makes it less than useful in many of the situations encountered by tax practitioners.[111]

V. Antichurning Rules Drive the Economic Deal

Even more troubling are situations, such as the one described below, in which parties to a legitimate business transaction are forced to alter the economic deal to which they agreed to avoid the application of the antichurning rules.

A PE fund wanted to acquire an interest in an existing LLC (Opco LLC) that had been formed before August 10, 1993, and was owned equally by a father and son. The father was planning to retire, but the son would continue to operate the business after the acquisition by the PE fund. To align the interests of the son with those of the PE fund, the PE fund wanted the son to retain a 25 percent interest in Opco LLC. A portion of the purchase price was to be financed using debt, and the remainder with equity supplied by the PE fund.[112] In connection with the loan, the lenders wanted to obtain a lien on all of the assets of Opco LLC and a pledge of all of the interests in Opco LLC. Also, the PE fund wanted to ensure it had the unilateral ability to force a sale of the business to a third party without having to rely on a ''drag along'' right in the operating agreement of Opco LLC. To accomplish both of these goals, it was determined that Opco LLC should become a wholly owned subsidiary of a holding company LLC (Holdco LLC) and that Holdco LLC should be owned 75 percent by the PE fund and 25 percent by the son. That way, Holdco LLC could pledge to the bank all of the equity of Opco LLC rather than receiving a separate pledge of interests in Opco LLC from the PE fund and the son. Also, the PE fund, which was in control of Holdco LLC, could itself cause Holdco LLC to sell all of the interests in Opco LLC to a purchaser.

From a U.S. federal income tax perspective, this could easily be accomplished by having Opco LLC transfer all of its assets and liabilities to a newly formed LLC in exchange for interests in the newly formed LLC. That transaction would be disregarded for U.S. federal income tax purposes because the newly formed LLC would be a disregarded entity for U.S. federal income tax purposes. The newly formed LLC would then become the operating company, and Opco LLC would become Holdco LLC. The PE fund could then purchase 75 percent of the interests in Holdco LLC and would be entitled to a basis step-up under section 743(a), assuming a section 754 election were in place or were made by Opco LLC for the year in which the purchase occurred, and the portion of the goodwill of the business indirectly purchased by the PE fund would be amortizable by the PE fund. Such a structure would have been impractical, if not impossible, from a corporate law perspective because it would have required an asset transfer and obtaining all of the attendant consents.

Instead it was determined that the PE fund would create a new LLC, Holdco LLC. The PE fund would contribute the cash that would be used to purchase the interests in Opco LLC to Holdco LLC. The formation of Holdco LLC and the contribution of cash to Holdco LLC would be disregarded for U.S. federal income tax purposes because Holdco LLC would be wholly owned by the PE fund. It was then contemplated that the son would contribute a 25 percent interest in Opco LLC to Holdco LLC in exchange for a 25 percent interest in Holdco LLC, which would enable the son to retain his continuing interest in the business. The son's contribution of this interest in Opco LLC to Holdco LLC in exchange for an

[111]This example changed from the proposed regulations under section 197 issued in 1997 to the final regulations that were issued in 2000. Notice of Proposed Rulemaking (REG-209709-94), 62 *Fed. Reg*. 2336 (Jan. 16, 1997), prop. reg. section 1.197-2(k), Example 17; T.D. 8865, 65 *Fed. Reg*. 3820 (Jan. 25, 2000), reg. section 1.197-2(k), Example 19. In the proposed regulations, this example said that the taxpayer formed the partnership with an affiliate and that the partnership interest was sold in an unrelated transaction. That language implied that if the partnership were formed in connection with the sale to the third party, no amortization would be permitted. The preamble to the final Treasury regulations stated that, in response to comments that the concept of an unrelated transaction creates a new standard for making determinations, the language of the example was changed and that existing step transaction principles would apply to making the determination of whether amortization would be permitted. This change would not seem to alter the result in a material way, but effectively admits a substance-over-form standard into these formalistic rules to reach a result that is less favorable to the taxpayer.

[112]The use of debt and the implications of a basis step-up under section 734(b), while interesting to consider, are not necessary for purposes of this example.

interest in Holdco LLC would cause Holdco LLC to become a partnership for U.S. federal income tax purposes, with the PE fund treated as having contributed to the partnership the cash that was in Holdco LLC.[113] Holdco LLC would then acquire all of the interests of the father and the remaining interests of the son in Opco LLC, such that Holdco LLC would own all of the interests in Opco LLC. When Holdco LLC acquired the 75 percent of Opco LLC that it did not already own, that transaction would be treated as an asset purchase for U.S. federal income tax purposes.[114] Holdco LLC would have a stepped-up basis in 75 percent of each of the assets of Opco LLC as a result of the deemed asset purchase.[115] Because Holdco LLC would be treated as related to the son, who maintained a 25 percent continuing interest in Holdco LLC, Holdco LLC would not be entitled to amortize the basis step-up attributable to the goodwill that was acquired.[116] In this case, a transaction form that would have been undertaken for a valid business purpose, and when the same end result could have been achieved with amortization of the acquired goodwill if the corporate law issues associated with asset transfers did not exist, could not be used to achieve the desired result because of the application of the antichurning rules.[117] Ultimately, the parties determined that to avoid the antichurning rules, the son would retain less than a 20 percent interest in Holdco LLC. The parties were required to change the business deal to achieve the amortization of the goodwill.

VI. Conclusion

The repeal of section 197(f)(9), the antichurning rules, would serve several important policy goals. Although many obstacles would remain, the repeal of section 197(f)(9) would be one small step toward tax simplification. It would promote fairness by eliminating the disparate treatment of taxpayers acquiring section 197 intangibles that were created on or before August 10, 1993, and taxpayers acquiring intangibles that were created after that date, as well as the inability to amortize section 197 intangibles that are subject to the antichurning rules, even though their value today may be 100 times greater than it was on August 10, 1993.[118] Finally, it would promote economic efficiency by enabling taxpayers to structure their transactions as they deem appropriate — for example, by encouraging management rollovers of more than 20 percent of the equity of the business in private equity transactions that may be considered important to the success of the transaction — rather than with a view to avoiding the application of the antichurning rules.

[113] *Supra* note 99.

[114] *Supra* note 100.

[115] Holdco LLC would not obtain a basis step-up regarding the portion of the assets of Opco LLC that were deemed to have been contributed to Holdco LLC in connection with the formation of the Holdco LLC partnership.

[116] Reg. section 1.197-2(k), Example 17.

[117] The transaction could also have been structured by having Holdco LLC purchase the LLC interests from the father and the son before the son's contribution of the Opco LLC interests to Holdco LLC. In that case, Holdco LLC would have acquired an interest in a partnership and a basis step-up under section 743, assuming a section 754 election was in effect or was made for the year of the acquisition. However, given that the two transactions would be occurring under a plan, the concern was that the IRS would view both the purchase of the partnership interests and the contribution of the Opco LLC interests by the son to Holdco LLC as a single asset acquisition, resulting in the same U.S. federal income tax consequences as discussed above.

[118] If the repeal of section 197(f)(9) were deemed too drastic, another approach would be to limit the nonamortizable portion of the section 197 intangible to its value on August 10, 1993. But because that approach would result in valuation issues, it would likely result in controversy and prove less efficient than repeal. Given the time that has passed since those rules were first enacted and the potential increase in value of any section 197 intangibles in the intervening period, one would expect the relative loss of revenue to the government resulting from a repeal of section 197(f)(9), as compared to the compromise position, to be insignificant.