IRET Institute For Research On The Economics Of Taxation

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

TAX TREATMENT OF INTANGIBLES

Statement Presented to the Committee on Ways and Means
U.S. House of Representatives
by
Norman B. Ture, President, and Carlos Bonilla, Senior Economist
Institute for Research on the Economics of Taxation
October 29, 1991

Mr. Chairman, members of the Committee, we are pleased to have the opportunity to present to the Committee our views concerning the appropriate income tax treatment of intangible assets. We believe the Committee is to be commended for turning its attention to this subject, long-neglected in the tax policy forums. The authors of the several bills addressing this matter have performed a valuable service in surfacing the issues concerning the recovery for tax purposes of the costs incurred in business acquisition of intangible property.

There are two major issues that should be addressed by legislation. The first is whether the value of intangible assets or the costs incurred to acquire them should be recoverable for tax purposes. The current tax treatment of intangibles, requiring both specific valuation of the intangible asset and a determinable "useful life," if the asset's cost is to be amortizable, precludes recovery for tax purposes of the cost of a significant and increasing amount of important business assets. The result is to increase the cost of capital invested in intangible property that may not be depreciated or amortized under present law. In turn, this distorts the relative valuations of differing kinds of intangibles. Any such distortion impairs efficiency, a particularly important consideration in this high-tech era in which intangible assets are an increasingly important component of production capability.

The second issue concerns the determination of the optimum type of cost recovery system for various types of intangibles.

The first issue arises primarily, but not solely, in the case of intangible assets acquired in connection with the purchase or acquisition of an ongoing business. The issue does not arise in the case of intangible assets created by the taxpayer, because most of the costs incurred in doing so are expensed as they occur. As a consequence, these assets have no basis that may be recovered for tax purposes at the time of their sale or other disposition. All of the proceeds of the stand-alone sale of such assets, therefore, are included in the seller's taxable income. If these assets are included in the sale of a business, the full amount of the sales proceeds that is attributable to such assets are included in reckoning the gain or loss realized on the sale. In the context of the present income tax, this treatment calls for no significant change.

In the case of a wide range of other intangibles that are purchased apart from the acquisition of a business, present-law treatment specifies essentially two conditions that must be satisfied if the cost of such assets is to be recoverable for tax purposes. One of these conditions is that the asset must be distinguishable from goodwill and have a determinable value, and the other is that the asset must have a determinable, finite "useful life." No single amortization schedule is prescribed for intangible assets that satisfy these conditions. While a number of questions may be raised about whether the present treatment of these assets is satisfactory when assessed against basic criteria of taxation, these questions are not pertinent with respect to the present legislative consideration. The current treatment of these intangibles, while not necessarily ideal, should not be altered by legislation that seeks to address the deficiencies in current law concerning other intangibles.

To repeat, the first issue arises principally in the case of intangibles acquired in the purchase or other acquisition of an ongoing business. In such cases, the value of all the intangibles acquired is the difference between the price paid for the business and the value of the acquired company's tangible assets. Under current law and regulations, the cost of those intangibles the value of which can be separately determined and for which a finite life can be determined may be amortized. The cost of the remaining amount of the intangibles, however, may not be ratably recovered for tax purposes over the period they are used by the acquiring taxpayer. If these assets are subsequently sold, either separately or in connection with the sale of the business, their cost basis is offset against the sales proceeds in determining the selling business's net gain or loss.

The issue which the Committee seeks to address comes up because the costs of a substantial amount of intangibles acquired in connection with the purchase of a business may not now be recovered for tax purposes at any time during the period in which these assets contribute to the generation of the acquiring company's income. Whether assessed in the context of the conventional view of the income tax or against the criterion of tax neutrality, correctly defined, the current law treatment overstates taxable income. It distorts, therefore, the valuation of such intangible assets and of the businesses that own them compared to the relative values these assets and businesses would otherwise have.

The issue also pertains to the competitive position of American businesses in the world market place. In the increasingly dynamic global business economy, the ability of American businesses to participate effectively more and more depends on their acquiring other businesses, frequently located in foreign jurisdictions. These acquisitions often are impelled by the opportunity to acquire a wide range of intangibles that provide a comparative advantage to the businesses that may use them. The inability to write off the costs of these intangibles obviously raises their cost to the would-be acquirer. The multinational businesses of many other countries do not encounter this sort of cost disadvantage and therefore have an edge over American businesses in bidding for targeted foreign companies.

By explicitly providing for the amortization of virtually all intangibles, H.R. 3035 marks a significant advance in the treatment of an important class of business assets. The bill implicitly recognizes that the costs of using all assets, intangible as well as tangible, must be accounted for in determining a business's taxable income.

On the other hand, by assigning a 14-year, straight-line amortization schedule for all acquired intangibles, the bill is seriously deficient in the way in which it addresses the second issue, that of the appropriate method for the recovery of these costs for tax purposes. It is also seriously deficient in that it replaces the current cost recovery treatment of intangibles acquired as stand-alone assets, requiring such assets to be amortized over the same 14-year time period as intangibles acquired as part of the acquisition of a trade or business.

This issue highlights the deficiency of the useful life approach to capital recovery in our present income tax. In real life, the useful life of virtually no production facility or asset can be determined with any confidence. The useful lives of many intangibles are particularly difficult to estimate; this is especially so in the case of intangibles that depend on or convey advances in technology. To insist that the costs of acquiring such assets from other businesses may not be recovered until the assets are sold by the acquiring businesses merely because there is no objective evidence on the basis of which to assign useful lives arbitrarily raises the costs of acquiring and using these assets.

Useful life is an improper and arbitrary basis for determining whether and in what way the cost of an asset may be amortized. The distinction drawn for tax purposes between computer hardware and software affords a telling example. In current law, a computer is a tangible asset that is written off on an accelerated schedule over five years. In fact, the computer is both hardware and software, the software having been burned into pieces of silicon that are part of the machine. Without the software on the silicon chips, the computer is not a computer; it is a paperweight. Take the same software and write it onto a disk instead of burning it into a chip, and that same software becomes an intangible asset instead of part of a tangible piece of property. Under H.R. 3035, it now would have to be amortized over 14 years at straight-line rates.

One of the unfortunate consequences of the proposed change in cost recovery of software would be to create pressures for uneconomic business practices in order to minimize the tax penalty. Software, rather than being cheaply and readily accessible on disks, could be reborn as hardware — chips. Obviously, although this might be a cost-minimizing way for a business to use the software input, it would not be efficient or cost-effective for the economy.

The criterion of tax neutrality should guide the design of the cost recovery method for intangible assets, just as it should for tangible property. In the broadest sense, tax neutrality means that tax provisions should not alter the relative prices, costs, or valuations that would be cast up by the operation of an efficiently operating free market. As a practical matter, since all taxes result in some distortions of one or more of these relative values, this important criterion of tax policy calls for minimizing the extent of these excise effects.

In the context of an income tax, neutrality calls for deducting business outlays, irrespective of the nature of the products or services acquired, as the outlays are made. Neutrality may also be achieved by spreading the deductions over several periods, provided that the present value of the deductions equals the amount of the outlays. Either approach would assure that income that is saved and used to acquire assets will be taxed no more heavily than income that is used for current consumption.

Even if, for whatever reason, the tax treatment of business outlays falls short of satisfying this "first-level" neutrality requirement, it may nevertheless satisfy a second-level requirement that the same effective tax rate applies in the case of all assets. The effective tax rate is the percentage increase in the present value of the pretax income that an asset must produce such that the present value of its after-tax earnings at least equals its cost. Equality of effective tax rates may be achieved by a capital recovery system in which the present value of the capital recovery deductions per dollar of capital is the same for all capital. Failing this, the income tax results in differing effective tax rates, hence differentially affects the market value of differing assets. This distortion of market valuations violates the neutrality criterion and results in less productive allocation of saving into alternative capital uses than would otherwise prevail.[1]

---

[1] For discussions and explanations of the concept of tax neutrality and the tax treatment required to achieve it, see Norman B. Ture, "The Accelerated Cost Recovery System: An Evaluation of the 1981 and 1982 Cost Recovery Provisions," in Charls E. Walker and Mark A. Bloomfield, eds., *New Directions in Federal Tax Policy for the 1980s*, Ballinger Publishing Company, Cambridge, Massachusetts (1983), pages 47-76; Carlos E. Bonilla, "'Accelerated,' 'Real,' and 'Neutral' Cost Recovery Systems in an Inflationary World," *Economic Report*, No. 26, IRET (Institute for Research on the Economics of Taxation); Norman B. Ture, "ACRS, ITC, and Tax Neutrality," *Economic Report*, No 25, IRET; Norman B. Ture and John B. Egger, "Corporations' "Fair Share" of Federal Taxes," National Chamber Foundation, Washington, D.C. (1988), pp. 30-45.

Capital recovery provisions under current law meet neither first-level nor second-level neutrality standards, but this deficiency does not justify ignoring this criterion when the law with respect to intangibles is to be revised. In terms of tax neutrality, the optimum approach would be to permit the expensing of all intangibles, no matter how acquired. Under this treatment, both first- and second-level neutrality tests would be passed. That is to say, with expensing, the income tax would not exert a bias against saving committed to investment in intangibles relative to current consumption uses of income, and the tax would be imposed at the same effective rate on assets of differing periods of expected usefulness. In contrast, assigning the same 14-year recovery period to all intangibles clearly would fail to meet the first-level neutrality standard, although it would satisfy the requirements of second-level tax neutrality.

For intangibles that may be amortized under current law over periods less than 14 years, H.R. 3035 would clearly increase the cost of such capital, the more so the shorter the recovery period allowed under current law. This effect is illustrated in the following table.

Cost of Capital Effect of 14 Year Amortization on Currently Amortizable Assets						
Current Law Amortization Period	2	5	10	14	20	25
Percent Change in Cost of Capital	+16.7%	+11.0%	+4.0%	0.0%	-4.4%	-7.1%

Thus, H.R. 3035 would be particularly harsh with respect to such intangibles as computer software for which relatively short recovery periods are provided under current law and regulations. In view of the critical role of this technology in business growth and competitive position, significantly increasing the cost of capital of software by requiring that it be written off over an artificially long period of time would be a seriously adverse policy shift.

We realize that there is virtually no disposition among tax policy makers to give serious consideration to expensing as the standard income tax treatment of capital outlays. We find this regrettable, particularly so because by failing to permit expensing, the economy is deprived of a substantial additional amount of productive capital that would contribute importantly to higher levels of output, productivity, employment, and income. It may not be deemed to be feasible to adopt expensing for any broad class of assets, let alone for all capital. There is, however, no justification for moving in the opposite direction by imposing a uniform, relatively long write-off period that would significantly increase the cost of capital for intangibles that may be amortized over much shorter period under current tax treatment.

One rationale advanced in favor of doing so is that such treatment would afford simplicity, eliminating disputes between taxpayers and the Internal Revenue Service and the burden on taxpayers to show the facts and circumstances that warrant assigning particular recovery periods to particular assets. This sort of simplicity could also be afforded by eliminating capital recovery allowances altogether, but clearly the resulting adverse effects on the cost of capital, capital formation, productivity advance, employment, output, and so on militate against simplification of this nature.

The other rationale for a uniform 14-year amortization period for all intangibles is that this would be "revenue neutral." We do not believe revenue neutrality is an appropriate guide for structural tax reform, no matter what the budgetary condition of the federal government may be. It is difficult, to say the least, to justify affording more favorable tax treatment with respect to the acquisition and use of some intangible assets while imposing far harsher tax treatment for others on the grounds that doing so will allegedly be revenue neutral.

Even were there some compelling reason to elevate revenue neutrality to the role of a guiding principle of taxation, one would be hard-pressed to determine a uniform write-off period for all intangibles that would be revenue neutral. The value of a substantial amount of the present stock of intangibles cannot be accurately determined, nor can the value of the stock of such intangibles at any given time in the future be confidently predicted. One need only observe the substantial changes in the market values of business equities occurring more or less continuously to grasp the extreme uncertainty about the amount of intangibles that would become eligible for amortization under H.R. 3035. Moreover, the mere enactment of H.R. 3035 would itself change the valuation of virtually all intangibles. Thus, even were revenue neutrality a useful constraint on the formulation of tax initiatives, it would be of little use in the present case in which there is so little basis for confident revenue estimation.

The basis for the treatment proposed in H.R. 3035 of the disposition of intangibles would be particularly harsh in the case of software but would also penalize dispositions of any tangibles before the prescribed 14-year amortization period was over. In cases in which the taxpayer disposes of some of the intangibles acquired in a particular transaction, no deduction would be allowed for the unrecovered basis of such assets. Instead, the adjusted basis of the intangibles acquired in the transaction that are retained would be increased by the amount of the unrecognized loss. For example, a taxpayer amortizing various software items acquired in a single transaction or series of transactions might well find that some of the software items become obsolete at the end of, say, two or three years. The taxpayer would be prohibited from writing off the unamortized basis in the year in which the software is scrubbed, but would have to carry it as an asset for another 11 or 12 years to recover its full cost.

Whatever one’s view concerning the appropriate method of cost recovery — expensing, accelerated depreciation, "economic" depreciation, etc. — the requirement that an asset’s full amortizable cost may be recovered over a longer period than it can be kept productively in service challenges justification. The proposed treatment, moreover, is all the more difficult to rationalize in that there would be no equivalent deferral of the tax on any gains realized on the disposition of intangibles.

We infer that considerations of minimizing revenue loss account for the proposed, anomalous treatment of disposition losses. Revenue considerations have too often in the last decade impelled inappropriate changes in the tax law. Minimizing revenue loss should not be permitted to erode whatever improvements in the law may be afforded by H.R. 3035.

The basic thrust of H.R. 3035 in allowing the writeoff of the costs of virtually all intangible assets, we believe, should be solidly endorsed. On the other hand, attaining the benefits from reducing the cost of capital invested in those intangibles that are not now amortizable should not be purchased at the price of greatly lengthening the amortization period of intangibles that may be amortized under present law. While expensing may well be deemed to be impractical at the present time, changes in the law should not move in the opposite direction for any class of property. We urge the Committee to provide the shortest possible writeoff period for intangibles not now amortizable, but to leave unaltered the amortization rules pertaining to intangibles that may be written off over shorter periods under present law.