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## The Treatment of Goodwill and Other Purchased Intangibles for Tax Purposes

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### The Effect of Section 197 on Goodwill

Enacted in 1993, Section 197 of the Internal Revenue Code (IRC) is known as the code section that finally made goodwill deductible for tax purposes. While this general notion is correct, Section 197 has a great deal of complexity and results in a lot of misunderstanding, which is probably not a surprise given that it is the tax code.

What is not as well-known about the deductibility of goodwill under Section 197 is that it applies only to deal structures in which the acquirer is able to “step-up and down” the basis of the target’s assets to their fair market values for tax purposes (e.g., taxable asset deals and taxable stock deals with 338, 338(h)(10), or 336(e) elections). These deals are often referred to as step-up basis (SUB) deals. Deals such as these produce goodwill for tax purposes when the purchase price is greater than the fair market value of the identifiable tangible and intangible assets.<sup>1</sup> When a SUB deal produces goodwill, Section 197 mandates that the acquirer must amortize it on a straight-line basis over 15 years.

In all other deal structures (e.g., taxable stock deals without 338, 338(h)(10), or 336(e) elections or tax-deferred reorganizations), the acquirer must maintain the basis that the target has in its assets before the transaction. These deals are often referred to as carryover basis (COB) deals. Because the acquirer maintains the target’s basis in the acquired assets, no goodwill is created from the transaction for tax purposes; therefore, no goodwill amortization exists to deduct.

### Financial Accounting for Goodwill

Acquisitions of corporations are usually COB deals.<sup>2</sup> Therefore, these acquisitions, especially when a publicly traded corporation is the target, *do not* generate goodwill for tax purposes. However, the financial statements of the acquirer likely report goodwill attributable to the deal even though there is no goodwill for tax purposes.

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<sup>1</sup> Technically, the Internal Revenue Service (IRS) requires the acquirer and target to use the residual method to allocate the purchase price to the target’s assets. The residual method is discussed later in this technical note.

<sup>2</sup> SUB deals are rarely seen in the acquisition of a parent C corporation. Some exceptions include when the parent C corporation has large net operating losses (NOLs) that will expire soon, or when the parent C corporation is foreign. SUB deals, specifically taxable asset deals, may be more common in the acquisitions of small, privately held C corporations for nontax reasons. SUB deals are more frequent in the acquisition of subsidiaries and pass-through entities, such as S corporations and limited liability companies (LLCs).

While Section 197 has governed the recognition of goodwill for tax purposes since 1993, the financial accounting standards have changed. Beginning in 1970 and lasting for over 30 years, the financial accounting standards amortized goodwill on a straight-line basis for no less than 40 years for certain deal structures. Then in a major shift, the Financial Accounting Standards Board (FASB) issued the Statements of Financial Accounting (SFAS) 141 and 142, effective for deals after June 2001. SFAS 141 required the purchase method for *all* acquisitions. Under the purchase method, the acquirer must step-up and down the basis of the target's assets to their fair market values for financial accounting purposes. A deal generates goodwill for financial accounting purposes when the purchase price is more than the fair market value of the identifiable tangible and intangible assets. If the transaction creates goodwill, then SFAS 142 does not allow the acquirer to amortize the goodwill. Instead, the goodwill is tested for impairment and reduced if it is found to be impaired. In 2007, FASB revised SFAS 141. The new standard (SFAS 141R) requires the acquisition method, which has many core concepts similar to the purchase method. The biggest differences arise with goodwill associated with noncontrolling interest, contingent considerations, deal fees, and the date used to determine the fair market value of the assets and liabilities acquired. The objective of the acquisition method is to capture the fair market value of 100% of the assets and liabilities at the time of the transaction. As a result, the acquirer must record goodwill for 100% of the target even when the acquirer buys less than 100%. Further, contingent consideration must be estimated at the time of the deal and capitalized as part of the value of the deal. On the other hand, the transaction fees associated with the deal, such as lawyer, accountant, and banker fees, are now expensed. Finally, the date of the transaction and not the announcement date are used to determine the fair market value of the assets and liabilities of the target company.<sup>3</sup>

In summary, COB deals do not generate goodwill for tax purposes but can generate goodwill, which will not be amortized, for financial accounting purposes. However, SUB deals can generate goodwill, which will be amortized over 15 years, for tax purposes and can generate goodwill, which will not be amortized, for financial accounting purposes (**Exhibit 1**).

In 2018, FASB decided to review the accounting for goodwill and intangibles again. The following year, FASB issued an exposure document for comment and sought input through much of 2019. On December 16, 2020, FASB signaled that it would reverse course at some point in the future by voting to require entities to amortize goodwill on a straight-line basis over a default period of 10 years, which is already allowed for private companies. FASB did not provide an effective date for its decisions and requested more analysis and feedback before moving forward. Thus FASB's intention is clear, but uncertainty remains regarding when and how the changes will be implemented.

### The Effect of Section 197 on Other Intangible Assets

In COB deals, the acquirer maintains the target's basis in the acquired tangible and intangible assets, so there is no change in the depreciation or amortization periods for tax purposes. For many internally generated intangible assets, the target's basis for tax purposes approximates zero, as most R&D costs are deducted immediately. In SUB deals, all tangible and intangible assets are recorded at their fair market values, and their depreciation or amortization periods are reset for tax purposes. The applicability of Section 197, which mandates that the acquirer amortize intangible assets on a straight-line basis over 15 years, varies by the type of intangible asset. **Exhibit 2** provides examples of intangible assets and identifies when Section 197 is applicable.<sup>4</sup> Section 197 is always applicable for some intangible assets, such as customer lists and formulas, irrespective of whether other assets are acquired. For other intangible assets, such as patents and copyrights, Section 197 is

<sup>3</sup> The accounting for goodwill is now codified as Accounting Standards Code (ASC) 350-20.

<sup>4</sup> Tangible assets are typically amortized for tax purposes over the period allowed under the modified accelerated cost recovery system (MACRS) in the IRC.

applicable only if associated with a SUB deal of a substantial part of the target's assets. In contrast, Section 197 is applicable for a covenant not to compete if associated with SUB or COB deals.

### Financial Accounting for Other Intangible Assets

The purchase method requires the acquirer to record all tangible and intangible assets at their fair market values and to employ the useful lives of the assets as the new depreciation and amortization periods for financial accounting purposes. The useful life for financial accounting purposes could easily differ from the period mandated for tax purposes under Section 197.

In summary, COB deals do not create a new cost basis or amortization period for the target's intangible assets for tax purposes, but they do generate a new historical cost and amortization period for its assets for financial accounting purposes. On the other hand, the acquirer in SUB deals records the target's assets at fair market value and establishes amortization periods for tax and financial accounting purposes, but the amortization periods for financial accounting purposes typically differ from those mandated by the IRC under Section 197 (**Exhibit 1**).<sup>5</sup>

### Valuation Implications

In COB deals, the difference in the basis of the target's assets for financial accounting and tax purposes is important for the acquirer to consider when valuing a target. While the acquirer will record a higher basis in the target's assets for financial accounting purposes, this higher basis will not generate larger depreciation and amortization deductions for tax purposes, thereby producing no additional future cash flow from tax savings. Additional future cash flow from tax savings is associated only with SUB deals where the acquirer records the target's assets at higher fair market values and generates larger depreciation and amortization deductions for tax purposes. In COB and SUB deals, the difference in the depreciation and amortization periods of the target's assets for financial accounting and tax purposes is another important valuation consideration. In COB deals, changes in the useful lives of the target's assets occur only for financial accounting purposes and do not affect future cash flows from tax savings. In SUB deals, it is important to realize that even though the acquirer records the target's assets at their fair market values and reevaluates their useful lives for financial accounting and tax purposes, only depreciation and amortization periods for tax purposes, which differ in most cases from the periods used for financial accounting purposes, affect the magnitude of the future cash flow from tax savings. For a detailed analysis of the use of financial statements to find the effect of these differences on cash flows, see "Differences between Financial Accounting and Tax for Valuation in M&A" (UVA-C-2421).<sup>6</sup>

### The Effect of Section 197 on Price Allocation across Assets in SUB Deals

In SUB deals, the acquirer takes a basis in the target's gross assets equivalent to the gross purchase price (i.e., consideration paid for the gross assets plus the target's liabilities assumed by the acquirer) and allocates the gross purchase price across all the purchased assets. The allocation of the gross purchase price is also relevant to the target because the taxable gain or loss on the sale of each asset is the asset's allocation of the gross purchase price less its tax basis. The IRS mandates the residual method, which allocates the gross purchase price in the following order up to each class's fair market value:

<sup>5</sup> COB and SUB deals create similar differences in the reporting of tangible assets for tax and financial reporting purposes.

<sup>6</sup> Frederick A. Elmore and Mary Margaret Frank, "Differences between Financial Accounting and Tax for Valuation in M&A," UVA-C-2421 (Charlottesville, VA: Darden Business Publishing, 2019).