NOTES

TAX TREATMENT OF LOSSES INCURRED ON THE SALE OR ABANDONMENT OF PURCHASED GOODWILL*

WHEN a taxpayer purchases a going concern whose earnings, because of public favor toward the concern or its products, exceed the normal rate of return for similar enterprises, that part of the purchase price attributable to such unusual earning power must be capitalized as "goodwill."[1] Courts deny

*Metropolitan Laundry Co. v. United States, 100 F. Supp. 803 (N.D. Cal. 1951).

1. Under the classical view of the free market, customers purchase only on the basis of quality and price. CHANDLER, A PREFACE TO ECONOMICS 41 (1946). In practice, however, patronage often results from friendships, reputation for quality, impressive surroundings, attractive packaging, extra services, or even sheer habit. 1 FAIRCHILD, FURNISS & BUCK, ELEMENTARY ECONOMICS 289-92 (5th ed. 1948); WAUGH, PRINCIPLES OF ECONOMICS 108-109 (1947); Foreman, *Conflicting Theories of Goodwill*, 22 COL. L. REV. 638, 638-9 (1922). Once the public is conditioned to react favorably toward, for example, a trade-name, trade-mark, location or the firm name itself, the right to use such symbols may acquire considerable value. Wright, *Some Relations Incident to a Sale of Goodwill*, 7 TENN. L. REV. 225, 235-6 (1929); *see* Ozone Co. v. U.S. Ozone Co. of Am., 62 F.2d 881, 885-6 (7th Cir. 1932). See also Wright, *Tort Responsibility for the Destruction of Goodwill*, 14 CORNELL L.Q. 298 (1929); Note, 1 STANFORD L. REV. 64 (1948). Thus the fair value of an established concern, based on its expected earnings, often exceeds substantially the reasonable value of a similar enterprise starting anew with the same tangible assets and with such intangibles as patents and copyrights. YANG, GOODWILL AND OTHER INTANGIBLES 94-6 (1927); 1 FINNEY, PRINCIPLES OF ACCOUNTING 308-09 (1937). Even a firm operating at a loss may possess valuable goodwill if a similar enterprise starting anew would suffer even greater losses. Dick & Bros. v. United States, 67 Ct. Cl. 505, 510-11 (1929); Pfleghar Hardware Co., 11 B.T.A. 361, 363 (1928), *rev'd*, 30 F.2d 614 (2d Cir. 1929); MILES, THE TREATMENT OF GOODWILL IN FEDERAL INCOME TAXATION 23 (NEBRASKA STUDIES IN BUSINESS No. 37, 1935); MONTGOMERY, AUDITING THEORY AND PRACTICE 280 (6th ed. 1940). This "excess" of earnings may be due to harmonious labor relations (industrial goodwill) and established lines of credit (financial goodwill), as well as to customer favor (consumer goodwill). See PATON, ADVANCED ACCOUNTING 398-400 (1947); YANG, *op. cit. supra*, at c. 3. For the variety of existing definitions of goodwill, see 1 CALLMAN, UNFAIR COMPETITION AND TRADE-MARKS 22-8 (2d ed. 1950); 10A MERTENS, LAW OF FEDERAL INCOME TAXATION § 59.36 (1948); Wright, *The Nature and Basis of Legal Goodwill*, 24 ILL. L. REV. 20 (1929); Foreman, *supra;* Metropolitan Bank v. St. Louis Dispatch Co., 149 U.S. 436, 446 (1892); White Tower System v. White Castle System, 90 F.2d 67, 69 (6th Cir. 1937).

The most widely employed method of valuing goodwill is to assume that tangible assets earn a "normal" rate of return and that the capitalization of all "excess earnings" determines the worth of a concern's goodwill. See A.R.M. 68, 3 CUM. BULL. 43 (1920); 10A MERTENS, *op. cit. supra*, §§ 59.37-59.44; MILES, *op. cit. supra*, at 13-30; Schwartz, *Goodwill in the Tax Law: A Correlation*, 8 TAX L. REV. 96, 97 (1952); Wolkstein, *Goodwill in Federal Income Taxation*, 24 TAXES 1158 (1946). As a result, accountants tend to equate goodwill with "excess earnings." PATON, ACCOUNTANTS' HANDBOOK 849 (1945);

amortization deductions for such purchased goodwill on the theory that although goodwill may fluctuate in value, it is never entirely lost so long as the firm continues to operate.[2] As a capital asset,[3] however, goodwill with a cost basis may reduce taxable income by providing a deductible loss[4] when disposed of in a "closed and completed transaction."[5] But since goodwill is not specific property and courts regard it as inextricably interwoven with

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YANG, *op. cit. supra*, at cc. 5, 6. See also GRAHAM & KATZ, ACCOUNTING IN LAW PRACTICE 277 (2d ed. 1938); Walker, *Accountants' Present Concept of Goodwill Depends upon Unusual Earning Power*, 91 J. ACCOUNTANCY 100, 102 (1951). But excess earnings may result from patents or monopoly power, factors excluded from the definition of goodwill adopted by many courts and used in this Note. Consolidated Gas Co. v. City of New York, 157 Fed. 849, 872 (2d Cir. 1907) (public utility monopoly not goodwill); Ruud Mfg. Co., 15 B.T.A. 819, 823 (1929), *aff'd*, 45 F.2d 63 (3d Cir. 1930) (value of patents excluded from goodwill). See MILES, *op. cit. supra*, at 13-30; Schwartz, *supra*, at 103.

Firms may pay sizable sums to acquire what they consider to be goodwill. In 1947 the Colgate-Palmolive-Peet Company purchased the Lustre-Creme Corporation, including in the purchase price $3,750,000 for goodwill. Gillette Safety Razor Company paid $15,955,970 for goodwill when it acquired the Auto-Strop Company in 1930, and more recently paid $8,000,000 for the goodwill of the Toni Company. RESEARCH DEP'T AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING TRENDS AND TECHNIQUES 52-3 (1950). These expenditures must be capitalized. Arthur P. Williams, 24 B.T.A. 1070 (1931); Dime Bank of Lansford, Pa., 20 B.T.A. 250 (1930); see also Hillside Dairy Co., 3 T.C.M. 174 (1944); A. M. Oliver, 1 T.C.M. 8, 11 (1942).

2. "[G]oodwill, in any practical sense, has no terminable life; but, rather, it continues in existence just so long as the business continues, and its value fluctuates in direct relationship with the annual variations in the profits of the business with which it is associated." Dodge Bros., Inc. v. United States, 118 F.2d 95, 100 (4th Cir. 1941). See also Red Wing Malting Co. v. Willcuts, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1926); Buckeye Producing Co., 11 B.T.A. 96 (1928). U.S. Treas. Reg. 111, § 29.23 (1)-3 (1943), permits a depreciation allowance for intangibles of limited life, and for those of indefinite life upon a showing that any remaining usefulness will cease within an ascertainable period. However, "goodwill" is specifically denied depreciation. See, *e.g.*, X-Pando Corp., 7 T.C. 48, 54 (1946); Bill Bros. Memorial Corp., 7 B.T.A. 1182, 1185 (1927), *appeal dismissed*, 41 F.2d 988 (10th Cir. 1930). For the origin of the no-depreciation rule, an interesting illustration of judicial gymnastics, see 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.119 (1942). See also Holzman, *Tax Classics*, 29 TAXES 231 (1951); MILES, THE TREATMENT OF GOODWILL IN FEDERAL INCOME TAXATION 44-5 (NEBRASKA STUDIES IN BUSINESS No. 37, 1935); Editorial, 49 J. ACCOUNTANCY 161 (1930).

3. Ensley Bank & Trust Co. v. United States, 154 F.2d 968, 969 (5th Cir.), *cert. denied*, 329 U.S. 732 (1946); Aaron Michaels, 12 T.C. 17, 19 (1949); Hillside Dairy Co., 3 T.C.M. 174, 175 (1944). See Note, 50 MICH. L. REV. 953 (1952).

4. Brewer v. Orr, 19 F.2d 230 (6th Cir. 1927). Mere fluctuations in the value of an asset cannot produce taxable gain or loss. United States v. White Dental Co., 274 U.S. 398, 401 (1927).

5. "In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed." U.S. Treas. Reg. 111, § 29.23(e)-1 (1943). See also U.S. Treas. Reg. 111, § 29.111-1 (1943).

the going concern, goodwill cannot be separated from the economic activities to which it is incident.[6] Hence, there can be no "closed transaction" leading to a deductible goodwill loss until the underlying "business" is terminated or sold.[7]

Whether a taxpayer may realize goodwill losses when he parts with less than his total enterprise presents a conceptual dilemma. Courts traditionally have considered goodwill an "indivisible" asset as well as inseparable from the underlying "business."[8] As a result, when companies discarded their principal activity but continued other operations—as brewers and distillers did during national prohibition—courts reasoned that there had been no "closed transaction" for purposes of recognizing goodwill losses.[9] On the other hand, common sense indicates that goodwill may attach to particular aspects of a concern, such as a product, special services, or the firm name, rather than to the bare legal entity through which operations are carried on.[10] The Commissioner and courts admit that goodwill is divisible, by permitting the realization of losses on purchased goodwill when part of the total enterprise is *sold,* even though the selling firm retains its physical assets or engages in some other form of trade.[11] And in *Metropolitan Laundry*

6. See Metropolitan Bank v. St. Louis Dispatch Co., 149 U.S. 436, 446 (1893); Dodge Bros. Inc. v. United States, 118 F.2d 95, 100 (4th Cir. 1941). See also U.S. Treas. Reg. 111, § 29.22(a)-10 (1943). However, goodwill may be sold with an underlying "business" which possesses no tangible assets, Pevely Dairy Co., 1 B.T.A. 385, 390 (1925), or which is not yet in actual operation, Coca-Cola Bottling Co. v. Coca-Cola Co., 269 Fed. 796, 806-07 (D. Del. 1920).

7. "A loss is sustained . . . only when it is a realized loss and is evidenced by a completed and closed transaction. . . . There could be no loss in respect of the good will until the business is terminated by sale or other disposition. . . ." Morand Bros., 8 B.T.A. 1262, 1266 (1927); followed in Buckeye Producing Co., 11 B.T.A. 96 (1928) (no "closed and completed transaction" even though taxpayer is operating under a different name and selling a new product to a new clientele).

8. Dodge Bros. Inc. v. United States, 118 F.2d 95, 101 (4th Cir. 1941); Morand Bros., 8 B.T.A. 1262, 1267 (1927). See also Garneau Co., 8 B.T.A. 1041, 1044 (1927).

9. E.g., Dick & Bros. v. United States, 67 Ct. Cl. 505 (1929); F. C. Renziehausen, 8 B.T.A. 87 (1927), *aff'd,* 280 U.S. 387 (1930). *But see* Moon Journal Pub. Co., 13 B.T.A. 1379, 1382 (1928); Multnomah Theatres Corp., 2 B.T.A.M. 370, 371 (1933).

10. See Wright, *Some Relations Incident to a Sale of Goodwill,* 7 TENN. L. REV. 225, 233-6 (1929); Wright, *The Nature and Basis of Legal Goodwill,* 24 ILL. L. REV. 20, 31-2 and nn.61-5 (1929); see also Grace Bros. v. Commissioner, 173 F.2d 170, 176 (9th Cir. 1949).

11. "Gain or loss from a sale of good will results only when the business, *or part of it,* to which the good will attaches is sold, in which case the gain or loss will be determined by comparing the sale price with the cost or other basis of the assets, including good will." U.S. Treas. Reg. 111, § 29.22(a)-10 (1943) (emphasis added). Brewer v. Orr, 19 F.2d 230 (6th Cir. 1927). *Cf.* Wawak Co. v. Kaiser, 90 F.2d 694, 698 (7th Cir. 1937); Devoy and Kuhn Coal & Coke Co. v. Commissioner, 23 B.T.A. 1335 (1931), *rev'd on an admission of error,* 66 F.2d 1012 (8th Cir. 1933); Stratton Grocery Co., 8 B.T.A. 317 (1927); Pevely Dairy Co., 1 B.T.A. 385 (1925).

Company v. United States,[12] a district court relied on the notion that goodwill is divisible to justify, for the first time explicitly, the recognition of goodwill losses upon the abandonment of an activity, distinct from other operations of the firm.[13]

The taxpayer in *Metropolitan* operated a laundry plant and delivery service in San Francisco and a similar enterprise, under a different name, in the adjacent city of Oakland. Under pressure of condemnation, the company in 1943 leased its San Francisco plant to the Federal Government and ceased deliveries on its San Francisco routes. Operations in Oakland continued undisturbed. The Government relinquished control of the San Francisco plant in 1946, but the company unsuccessfully attempted to regain its civilian business. Three years later the company permanently closed the plant and discontinued the delivery service. Since the company had purchased the laundry routes from other companies, it claimed that the abandonment of the routes established an ordinary loss for 1943 and sued for a refund of taxes paid.[14]

The district court sustained the taxpayer's contention over the defense that there had not been a "closed transaction." The government argued that Metropolitan's laundry routes formed an indivisible part of the total corporate goodwill and were inseparable from the taxpayer's "business." Since the company did not withdraw completely from laundry service, there was no "closed transaction"; any loss should be considered only as a fluctuation in the value of total corporate goodwill. But the court, admitting that goodwill is indivisible and inseparable, defined "business" more narrowly. Pointing out that the laundry "business" in San Francisco was entirely distinct from operations in Oakland, the court found that the goodwill incident to

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12. 100 F. Supp. 803 (N.D. Cal. 1951).

13. One court allowed a taxpayer to recognize a goodwill loss on a partial abandonment of a going concern. But the court did not use the term "goodwill," and instead referred only to the "capital expenditure" lost on the abandonment of the "enterprise." Reuben H. Donnelley, 26 B.T.A. 107, 114 (1932). *Cf.* United States v. Hardy, 74 F.2d 841 (4th Cir. 1941) (abandonment of a sales agency); Paul Jones & Co. v. Lucas, 15 A.F.T.R. 681 (W.D. Ky. 1931) (trade-mark abandoned); Sheffield Dentifrice Co., 13 B.T.A. 877 (1928) (trade-mark abandoned while enterprise continued); David Schwartz Co., I.T. 1505, I-2 CUM. BULL. 112 (1922) (development costs when branch plant abandoned); 5 MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 28.19 (1942). See Landsberger v. McLaughin, 26 F.2d 77 (9th Cir. 1928). However, most cases prior to *Metropolitan* suggested that goodwill losses could be recognized *only* upon a *sale* of the enterprise to which the goodwill attached. See National Industrial Alcohol Co., Inc. v. Commissioner, 38 F.2d 718 (D.C. Cir. 1930), *aff'd*, 282 U.S. 646 (1931). See also Red Wing Malting Co. v. Willcuts, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1926); Garneau Co., 8 B.T.A. 1041, 1044 (1927); I.T. 1995, III-1 CUM. BULL. 145 (1924); National Chem. Mfg. Co. v. United States, 67 Ct. Cl. 607, 612 (1929) (goodwill loss denied when taxpayer abandons his entire enterprise); Schwartz, *Good Will in the Tax Law: A Correlation*, 8 TAX L. REV. 96, 99 (1952).

14. See INT. REV. CODE § 23(f).

the San Francisco routes had disappeared completely, thus entitling the company to recognize the loss of its cost basis.[15] Moreover, the opinion suggests that even if the taxpayer had continued to run its San Francisco plant, abandonment of the delivery service would have terminated the only "business" to which the goodwill of route patrons could possibly attach.

Superficially, *Metropolitan* presents an appealing solution to the problem of goodwill losses through partial abandonment. Purchased goodwill, incident to a particular economic activity, may increase earnings only so long as the taxpayer continues the activity. When a phase of the concern is abandoned, any benefit from the incident goodwill is permanently lost. Recognition of partial goodwill losses through abandonment thus seems fair—particularly since taxpayers may now deduct losses on purchased goodwill if the losses are incurred in a sale of part of the enterprise. Moreover, by requiring the termination of at least some part of the going concern, *Metropolitan* preserves an identifiable event to satisfy the "closed transaction" test. And since only goodwill with a provable cost basis may lead to a deductible loss,[16] opportunities for taxpayer abuse are minimized. Hence, partial abandonment loss deductions do not impose an undue burden on either the Commissioner or the courts.

The *Metropolitan* rationale, however, may induce unnecessary litigation by encouraging taxpayer manipulation. The case does not limit the scope of the "business" necessary to sustain a deduction to geographically separate activities. The court's reasoning could apply with equal force to abandonment of a product, location, or corporate name. Taxpayers may terminate relatively insignificant portions of their going concerns at advantageous moments, claiming a deductible loss on the ground that they abandoned a "business" to which purchased goodwill (with a provable cost basis) had attached. Moreover, taxpayers might allocate excessive portions of purchased goodwill to phases of the enterprise admittedly broad enough to sustain a loss deduction.

15. The court apparently thought that the company's maximum deductible loss was the 1943 value of its routes. And the court found that the 1943 value of the routes equaled or exceeded the initial cost. Metropolitan Laundry Co. v. United States, 100 F. Supp. 803, 806 (N.D. Cal. 1951). *Cf.* Nat. Chem. Mfg. Co. v. United States, 67 Ct. Cl. 607, 611 (1929). However, such a limitation on the amount of the deductible loss clearly seems erroneous. Losses are normally computed by subtracting the amounts received upon disposition of an asset from the asset's adjusted basis. The adjusted basis usually is cost *less* all obsolescence, amortization, and depreciation actually "sustained" prior to March 1, 1913, *less* all obsolescence, amortization, and depreciation "allowable" under the Code after March 1, 1913. INT. REV. CODE § 113. Since taxpayers are denied deduction for the obsolescence, amortization, and depreciation of goodwill, the maximum deductible loss must be goodwill's initial cost (or its March 1, 1913, value if lower). For the computation of goodwill losses in sales cases, see U.S. Treas. Reg. 111, § 29.22(a)-10 (1943).

16. This requirement is implicit in the *Metropolitan* case. See also Brewer v. Orr, 19 F.2d 230 (6th Cir. 1927). And see U.S. Treas. Reg. 111, § 29.22(a)-10 (1943). However, the March 1, 1913, value of goodwill may be used to reduce the gain on the sale of goodwill. See INT. REV. CODE § 113(a) (14).

Although courts doubtlessly would see through most, if not all, of these maneuvers, taxpayers nevertheless may be tempted to seek unwarranted abandonment losses. Of course, the same problems of "business" scope and a realistic allocation now exist in partial sales. Limited only by the need to find a willing buyer, taxpayers may sell relatively minor portions of the concern in an effort to realize goodwill losses.[17] And an unrealistic allocation of goodwill's cost basis may precede the sale.[18] However, with tax avoidance as the goal, abandonment might well be more attractive than a sale; abandonment losses are deductible from ordinary income while goodwill losses upon a sale fall into the capital loss category.[19]

The availability of deductions for piecemeal abandonment losses might even prove to be a boomerang to taxpayers and further invite litigation. To bar claims for goodwill losses on partial sales or partial abandonment, the Commissioner could argue that part or all of the taxpayer's total goodwill had been attached to a phase of his enterprise—a "business"—previously abandoned.[20] Thus the cautious taxpayer may claim goodwill loss deductions prematurely because he is terminating a facet of his enterprise which the Commissioner conceivably might label a "business" at a later date. Even if the Commissioner's argument fails, the taxpayer who abandons a "business" may be unable to prove the cost of that part of his total goodwill which is incident to it and thus be denied a deduction because of no provable basis.[21] And if the taxpayer cannot prove a cost basis for the lost goodwill, he may in later years be unable to show the cost of the goodwill which had remained. As a result,

17. See Grace Bros. v. Commissioner, 173 F.2d 170 (9th Cir. 1949); William M. Wailes, 25 B.T.A. 278 (1932). *Cf.* Acme, Palmers & De Mooy Foundry Co. v. Commissioner, 21 F.2d 492 (N.D. Ohio 1927), *aff'd,* 30 F.2d 1007 (6th Cir. 1928).

18. See Fraser v. Nauts, 8 F.2d 106 (N.D. Ohio 1925).

19. "The term . . . capital loss . . . means loss from the *sale or exchange* of a capital asset. . . ." INT. REV. CODE §§ 117(a)(3), 117(a)(5) (emphasis added). "The limitations provided in section 117 with respect to the *sale or exchange* of capital assets have no application to losses due to the *discarding* of capital assets." U.S. Treas. Reg. 111, § 29.23 (e)-3 (1945) (emphasis added) (regulation applicable to individuals). This provision is made applicable to corporations by U.S. Treas. Reg. § 29.23(f)-1 (1943). The loss in the instant case was treated as an ordinary loss. Metropolitan Laundry Co. v. United States, 100 F. Supp. 803, 804-05 (N.D. Cal. 1951).

20. The statute of limitations may bar a reopening of the return for the earlier year. See INT. REV. CODE § 1636. For a general discussion of the problem of deductibility and the statutory time limit, see Brown, *The Time for Taking Deductions for Losses and Bad Debts for Income Tax Purposes,* 84 U. OF PA. L. REV. 41 (1935).

21. Hall-Luhrs & Co., 6 B.T.A. 320 (1927). For the difficulty inherent in determining the cost basis of goodwill, see Meurer Steel Barrel Co., 1 T.C.M. 721 (1943), *aff'd,* 144 F.2d 282 (3d Cir. 1944), *cert. denied,* 324 U.S. 860 (1945); Cherokee Motor Coach Co., 11 B.T.A.M. 365 (1942), *aff'd,* 135 F.2d 840 (1943); Sanderson v. Commissioner, 42 F.2d 160 (2d Cir. 1930); Central Bank of Lincoln, Neb., 29 B.T.A. 719 (1934); Nice Ball Bearing Co., 5 B.T.A. 484 (1926); Westfield & Fall River Lumber Co., 4 B.T.A. 135 (1926).

he could be foreclosed from his loss entirely.[22] In partial sales cases, taxpayers now encounter the problem of proving a realistic allocation.[23] But at least taxpayers are not encouraged, in the absence of a doctrine permitting partial abandonment losses, to claim goodwill losses prior to an actual sale.

Even if there is no doubt that a taxpayer has abandoned a "business" to which goodwill with a provable cost basis had attached, the need to determine the year of abandonment presents a litigious issue. Non-use of an asset is insufficient to prove an abandonment: there must also be evidence that the taxpayer *intends* the non-use to be permanent.[24] The *Metropolitan* case aptly illustrates the problem of determining the existence of the requisite intent. Although the laundry company, after leasing its plant, sold its trucks and halted delivery service in 1943, it did not report a loss in its 1943 tax return. The company made no effort to sell the routes; and, as soon as the plant was returned, it attempted to regain its civilian business. Such acts seem incompatible with an intent in 1943 to withdraw from the "business" permanently. Probably not until 1949, when the corporation voluntarily ceased its San Francisco operations, was there a clear intent to "abandon." Yet the court assumed that the non-use of the San Francisco laundry "business" in 1943 also meant that an abandonment occurred in that year.

Although the intent requirement renders abandonment a nebulous "identifiable event," neither non-use alone nor the actual deterioration of goodwill is a satisfactory alternative. Non-use offers no assurance that the taxpayer will not resume his activities after recognizing the goodwill loss.[25] And to ascertain when goodwill—consisting of public favor for a "business"—is actually lost would require findings even more difficult than a determination of intent.[26] In sales cases, courts normally have no difficulty deciding the appropriate year for recognition of goodwill losses; the date of the sale marks the year.[27] Moreover, the seller's express or implied promise not to interfere

22. Courts may avoid this result by applying to goodwill the treatment now accorded to *securities* purchased in a block. When the purchaser is unable to allocate the cost among the individual stocks and bonds acquired, no loss will be realized until all the securities are disposed of or no gain until the total cost basis has been recovered. See, *e.g.*, Pierce v. United States, 49 F. Supp. 324 (Ct. Cl. 1943); Piper v. Commissioner, 5 T.C. 1104 (1945). See also 1 RABKIN & JOHNSON, FEDERAL TAXATION § 33.02(4) (1951).

23. See cases cited in note 21 *supra.*

24. *E.g.*, Boston Elevated Ry., 16 T.C. 1084 (1951); Ewald Iron Co., 37 B.T.A. 798, 799 (1938); Belridge Oil Co., 11 B.T.A. 127, 137 (1928). See 5 MERTENS, LAW OF FEDERAL INCOME TAXATION § 28.18 (1942).

25. *See* Chas. J. Michel Beverage Co., 10 B.T.A.M. 854, 856 (1941).

26. *See* Dodge Bros., Inc. v. United States, 118 F.2d 95, 100 (4th Cir. 1941); Washburn v. National Wallpaper Co., 81 Fed. 17, 21 (2d Cir. 1897); Manhattan Brewing Co., 6 B.T.A. 952, 960-1 (1927).

27. U.S. Treas. Reg. 111, § 29.22(a)-10 (1943). See United States v. Huntington Laboratories, 82 F.2d 356, 357 (7th Cir. 1936).

with the buyer's enjoyment of the transferred benefits ensures that the seller no longer will benefit from that goodwill.[28]

The harshness of present tax treatment of purchased goodwill may explain the *Metropolitan* court's willingness to permit partial abandonment losses. Advertising, promotional, and similar expenditures designed to create public favor are generally deductible from ordinary income as business expenses.[29] Yet outlays for ready-made goodwill cannot offset taxable income until some subsequent disposition of the "business" to which all or part of the goodwill is incident.[30] However, the value of goodwill probably does not remain constant. Competition, technological innovation, and changes in consumer preferences or habits may erase purchased goodwill.[31] Thus, the ban against any deductions for decrements in the value of purchased goodwill forces the tax-

28. The rule is not identical in all jurisdictions; yet it is generally accepted that in the absence of an express covenant not to compete, the vendor may compete with his vendee but may not impair the vendee's enjoyment of the transferred benefits. See, *e.g.*, Mutual Life Ins. Co. v. Menin, 115 F.2d 975 (2d Cir. 1940); Dairymen's League Co-op Ass'n v. Weckerle, 160 Misc. 866, 291 N.Y. Supp. 704 (Sup. Ct. 1936).

29. Three-in-One Oil Co. v. United States, 35 F.2d 987 (Ct. Cl. 1929) (advertising); F. E. Booth, 21 B.T.A. 148 (1930) (advertising); B. F. Boyer, 4 B.T.A. 180 (1926) ("public service" advertising); J. H. Gorsuch, 3 T.C.M. 1307 (1944) (entertainment of customers); Liberty Insurance Bank, 14 B.T.A. 1428 (1929) (miniature banks distributed to customers); Rodgers Dairy Co., 14 T.C. 66 (1950) (gifts to suppliers); Popular Dry Goods Co., 6 B.T.A. 78 (1927) (employee dances and picnics); R. S. LeSage, 6 T.C.M. 1263 (1947) (cost of Christmas party). See also INT. REV. CODE § 23(bb) (by a 1950 amendment: expenditures to increase newspaper circulation); INT. REV. CODE § 23-(q) (charitable contributions). However, expenditures "solely for goodwill" are not deductible. Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir. 1937), *cert. denied*, 302 U.S. 722 (1937); Pevely Dairy Co., 1 B.T.A. 385 (1925); Benjamin Miggins, 8 T.C.M. 82 (1949); A. M. Oliver, 1 T.C.M. 8, 11 (1942). The relative permanence of the purchased benefits seems to be the criterion of whether a cost must be capitalized or may be presently deducted. However, even this test cannot reconcile the cases.

30. Many authorities urge the adoption of goodwill amortization as a standard accounting practice. LEAKE, COMMERCIAL GOODWILL 76-7, 98 (4th ed. 1948); PATON, ADVANCED ACCOUNTING 409 (1947); YANG, GOODWILL AND OTHER INTANGIBLES 189-201 (1927); Rolnik, *The Probable Life of Goodwill as a Basis for Depreciation*, 9 TAX MAG. 248 (1931). For the contrary position, see GRAHAM & KATZ, ACCOUNTING IN LAW PRACTICE § 185, p. 279 (2d ed. 1938); 1 FINNEY, PRINCIPLES OF ACCOUNTING 317 (1937); MONTGOMERY, AUDITING THEORY AND PRACTICE 498 (6th ed. 1940). For a summary of the various accounting techniques of treating goodwill, see Preinreich, *Goodwill in Accountancy*, 64 J. ACCOUNTANCY 28, 36-44 (1937); Kripke, *A Case Study in the Relationship of Law and Accounting: Uniform Accounts 100.5 and 107*, 57 HARV. L. REV. 433, 459-61 (1944). See also Gulf Power Co., 10 T.C. 852 (1948).

31. Accountants are split on the question of whether purchased goodwill declines in value when a business firm maintains its superior earning power. See references cited in note 30 *supra*; May, *Income Taxes and Intangibles: Two Significant Research Bulletins*, 79 J. ACCOUNTANCY 124, 128 (1945); PATON, ACCOUNTANTS' HANDBOOK 849-51 (1945). And *see* Metropolitan Bank v. St. Louis Dispatch Co., 149 U.S. 436, 446 (1893); Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945) (suggests that goodwill is a depreciable asset).

payer to overstate his real income, as he would if he were denied deductions for ordinary advertising costs or the depreciation of machinery.[32] The hope of an eventual loss deduction upon a partial sale offers small comfort to taxpayers denied amortization deductions since evidentiary obstacles to proof of a basis often preclude recognition of loss.[33] And many taxpayers may *never* dispose of the totality of their enterprises through either sale or abandonment.

Two problems would confront the Commissioner initially if he were to permit the amortization of purchased goodwill:[34] the length of the amortization period; and the appropriate treatment of large amounts of purchased goodwill now on the books of many corporations. The amortization period necessarily must be arbitrary since the actual life of goodwill defies accurate measurement.[35] Perhaps the Commissioner would impose a minimum period,

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32. See Yang, Goodwill and Other Intangibles 195, 206-08 (1927).

33. Dodge Bros., Inc. v. Commissioner, 118 F.2d 95, 101 (4th Cir. 1941). See note 21 *supra*. See also Acme, Palmers & De Mooy Foundry Co. v. Commissioner, 21 F.2d 492 (N.D. Ohio 1927), *aff'd*, 30 F.2d 1007 (6th Cir. 1928).

34. This Note has defined goodwill as public favor towards an enterprise or its products. See note 1 *supra*. If amortization of expenditures for "public favor" were permitted, taxpayers necessarily would be able to deduct outlays for items which do not fall within the "public favor" category, such as monopoly power or developmental costs. This results from the impossibility of valuing "public favor" directly. Only capitalized earnings in excess of a normal return on tangible assets can prove the existence of "public favor." Yet the presence of excess earnings may be due to monopoly power rather than "public favor." See note 1 *supra*. Since there is no practical means of determining the source of excess earnings, the amortization of expenditures for the intangible "goodwill" may well involve amortization of non-goodwill costs. The amortization of such costs also seems justified. The life of intangibles other than goodwill is probably limited too. Leake, Commercial Goodwill 25 (1948). And although the useful life of such intangibles may be even more difficult to estimate than the life of "public favor," a write-off over an arbitrary period seems more reasonable than a denial of any recognition for tax purposes until the taxpayer terminates his enterprise. For a discussion of the problem, see Yang, Goodwill and Other Intangibles c. 6 (1927) (favors the write-off of all intangibles over the period utilized in capitalizing the excess earnings).

35. See references in note 24 *supra*. The Commissioner has never demanded absolute precision in fixing the "useful life" of depreciable assets, and accepts estimates based on the usual experience of property owners. See Bulletin "F" (Rev. Jan., 1942), 1 CCH 1953 Fed. Tax Rep. ¶ 219.288. Courts have accepted arbitrary determinations of an asset's useful life when there is no alternative yardstick. The cost of covenants not to compete may be amortized over the legal, rather than useful, life of the vendor's promise. B. T. Babbit, Inc., 32 B.T.A. 693 (1935); Carboloy Co., Inc., 2 T.C.M. 413 (1943); *cf.* Christensen Machine Co., 18 B.T.A. 251 (1929). Copyrights and patents are also depreciable over their legal lives. See U.S. Treas. Reg. 111, § 29.23(1)-7 (1943). See also Yang, Goodwill and Other Intangibles 197 (1927). Although modern concrete and steel buildings may last almost indefinitely, the Commissioner permits full depreciation over a 40 to 75 year period. See Bulletin "F" (Rev. Jan., 1942), 1 CCH 1953 Fed. Tax Rep. ¶ 219.299. The cost of an advertising campaign has been held deductible over a period estimated to correspond with the effective life of the campaign's impact on the purchasing public. *E.g.*, Liberty Insurance Bank, 14 B.T.A. 1428 (1929).

possibly twenty years, for all enterprises. Such a period would prevent too rapid write-offs in current high tax years and also provide a simple method of handling the present accumulations of goodwill. If all such accumulations were permitted amortization treatment, many large corporations could markedly reduce their taxable income in the coming years by taking large deductions.[36] Besides producing generous tax savings, these deductions would distort actual income, since the goodwill initially purchased probably has disappeared[37] and expenditures to develop goodwill are likely to have been deducted as business expenses.[38] Thus, taxpayers should not be allowed to amortize goodwill which they purchased more than twenty years ago. Goodwill purchased more recently might be accorded amortization treatment on a pro rata basis until twenty years have elapsed from the date of purchase.[39] Goodwill remaining unamortized may then be carried on the taxpayer's books and subjected to its present tax treatment.

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36. The list of corporations with large accounts of purchased goodwill includes: The Coca-Cola Co.—$41,440,683 ("Formulae, Trademarks, Goodwill"); Du Pont (I. E.) de Nemours & Co.—$42,071,641 ("Goodwill, Patents, Trademarks, etc."); General Motors Corp.—$63,214,330 ("Goodwill, Patents, etc."). MOODY'S INDUSTRIALS 1624, 1808, 2255 (1952). See also last paragraph of note 1 *supra*.

37. See notes 30 and 31 *supra*.

38. See note 29 *supra*.

39. To illustrate: XYZ Corporation purchases a "business" on January 1, 1940, $20,000 of the sales price being allocable to goodwill. Assuming that amortization will commence on January 1, 1954, $14,000 (or 14/20's of the cost) would be denied amortization treatment. $1,000 (or 1/20 of the cost) could be amortized in 1954 and in each of the following five years.