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Goodwill Hunting Gone Bad: Tax Law's Outmoded Treatment of Goodwill

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I. INTRODUCTION

Prior to 1993, the tax rules motivated the Internal Revenue Service (IRS) to "hunt for goodwill." Due to the lack of depreciation deductions for goodwill,[1] business buyers typically allocated minimal purchase price to this asset.[2] Buyers instead apportioned their costs to depreciable assets like customer lists.[3] The IRS typically reallocated significant amounts back to nondepreciable goodwill.[4] In response to all the difficult litigation,[5] Congress enacted § 197 in 1993. This section provides business buyers the same fifteen-year depreciation recovery on goodwill, customer lists, trademarks, patents, copyrights, and many other intangible assets. By equalizing the treatment of

1. The term "amortization" is used sometimes instead of "depreciation" for intangible assets. As the concepts are the same, this Article uses the more popular *depreciation* term to reference both depreciation and amortization for ease of exposition.
2. Tax depreciation is allowed for "wasting" assets: i.e., those which lose value over time from usage. And the tax law assumes that goodwill does not waste away over time. I.R.C. § 167 (2012) ("There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . ."); Treas. Reg. § 1.167(a)-3 (as amended in 2004) ("If an intangible asset is . . . to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. . . . No deduction for depreciation is allowable with respect to goodwill.").
3. In order to sustain this position, the taxpayer had to establish both the value of the separate asset and its limited useful life. *See supra* note 2.
4. *See, e.g.*, Newark Morning Ledger v. United States, 507 U.S. 546 (1993).
5. This litigation was highly contentious given the difficulties of allocating the overall purchase price among the various acquired assets. As discussed *infra* note 20, tax law treats a business sale as a separate sale of each individual asset.

goodwill and other related intangibles, Congress effectively circumvented the IRS's unsatisfying hunt for goodwill.[6]

In an interesting reversal, recent regulations publicized how taxpayers now seek goodwill. Prior to the recent regulatory and Tax Code changes, international tax rules incentivized taxpayers to inflate goodwill on transfers to their foreign subsidiaries.[7] This flowed from a goodwill exception to the regular gain-recognition rules on such transfers.[8] Recent regulations targeted this particular loophole, explaining why the tax law should not differentiate between goodwill and other closely related intangibles.[9] But while the recent tax bill shuts down this specific goodwill pursuit, meaningful goodwill-hunting mischief remains fully intact in several other significant areas.

For instance, a less publicized case involved a taxpayer's sale of its international operations to an unrelated buyer.[10] The seller claimed a hefty goodwill allocation to boost its foreign tax credit allowance. Different income sourcing rules for goodwill and related assets encouraged this taxpayer attempt.[11] And since this involves the sale of assets to a third party, the recent change to subsidiary transfers does not impact this goodwill incentive.

The Internal Revenue Code (the Code) likewise incentivizes business sellers to allocate more towards goodwill in order to maximize income taxed at favorable capital gains rates. For instance, § 1253 denies the lower capital gains rates to contingent payments for trademarks (and franchises) but not for goodwill and other intangibles. In addition, even fixed-payment sales can trigger goodwill-hunting opportunities due to specialized capital gains rules applicable solely to select types of intellectual property (i.e., copyrights and patents).[12]

These varying capital gains rules for business sellers ignore the lessons of the recent regulations and § 197. This Article thus proposes several corrections to the ongoing goodwill difficulties. As developed in the roadmap below, the foreign sourcing of intangibles gains should be keyed to the foreign taxation of such gains rather than the presence of

6. *See infra* section II.A.
7. *See infra* section III.A.
8. *See infra* section II.A.
9. *See infra* Section III.A.
10. For further discussion of *International Multifoods v. Commissioner*, 108 T.C. 25 (1997), see *infra* section II.B.
11. Section 865(d)(3) provides favorable foreign sourcing to goodwill, while § 865(d)(2) provides disfavored U.S. sourcing to other intangibles. *Compare* I.R.C. § 865(d)(3) (2012), *with id.* § 856(d)(2). And as discussed *infra* notes 66–74 and accompanying text, foreign-source income from a goodwill allocation increases the allowable foreign tax credits as an offset to the U.S. tax liability.
12. On the one hand, § 1235 provides taxpayer-friendly rules for capital gains to patent inventors. In the other direction, § 1221(a)(3) provides a taxpayer-unfriendly rule which denies capital gains to copyright developers. For a fuller discussion, see *infra* notes 117–19 and accompanying text.

goodwill. Next, § 1253 should eliminate trademarks from its coverage. Third, similar to the § 197 rules for buyers, uniform capital gains rules should apply to business sellers regardless of the nature of the intangible assets.

This Article proceeds as follows: Part II chronicles how the government's goodwill-hunting efforts prior to 1993 culminated in the enactment of § 197. In addition to providing useful background information, this Part also presents two illustrative examples based on former Baseball Commissioner Bud Selig's actual tax case.

Part III then further utilizes these examples to illustrate the bountiful goodwill-hunting opportunities for taxpayers. As discussed above, this role reversal flows from the differential tax-favored treatment of goodwill in the subsidiary transfer, foreign tax credit, and capital gains areas.

After Part III's exposition of current law's problematic areas, Part IV presents incisive solutions for each area.[13] Section IV.A first addresses the goodwill sourcing problem under current § 865. Goodwill currently operates as a poor proxy for the ultimate target: foreign taxation of the intangibles gain. In addition to the valuation difficulties highlighted above, goodwill does not accurately capture the desired foreign taxation even in theory.[14] Fortunately, an existing treaty-sourcing provision provides the pathway for reform: link the taxpayer-desired foreign sourcing to the actual foreign taxation of the intangibles gain.[15] Drawing upon this proven approach should counteract the usual status quo bias against untested reforms.[16]

Section IV.B next tackles the problematic inclusion of trademarks in § 1253 (along with franchises).[17] This encourages taxpayers to allocate contingent payments away from trademarks and towards goodwill. Section 1253 should be scaled back to apply only to franchises for several reasons. As a starting point, the legislative history reflects congressional concern primarily over franchises, with trademarks added more as an afterthought. In addition, trademarks raise real prac-

13. Since each area operates separately, some or all of the proposals could be implemented.
14. *See infra* notes 135–36 and accompanying text.
15. The treaty rules also incorporate a separate foreign-tax-credit limitation to avoid manipulations in the case of low foreign tax rates. *See infra* notes 139–40 and accompanying text.
16. *See, e.g.*, Wolfgang Alschner, *The Impact of Investment Arbitration on Investment Treaty Design: Myth Versus Reality*, 42 YALE J. INT'L L. 1, 51 (2017) ("[I]nvestment law suffers from status quo bias: path dependency dominates over prolific innovation. Treaty design evolution, where it takes place, consists of states opting into and refining tried and tested language rather than trying out something new. This path dependency prevents more radical change, even where this change may be on balance beneficial.").
17. Section 1253 also covers trade names in addition to trademarks and franchises. For ease of exposition, the textual reference to trademarks includes trade names.

tical issues avoided in the franchise context. For instance, franchises typically subsume all the business goodwill, thereby minimizing the problematic allocation issues.[18]

Finally, section IV.C addresses the other relevant capital gains provisions for business sellers. In particular, § 1235 facilitates capital gains for certain patents, while § 1221(a)(3) denies capital gains for certain copyrights. Interestingly, this mixture of favorable and undesired rules presents the inverse sellers' side to the buyers' difficulties prior to § 197. Such recognition suggests the comparable fix here: application of standardized rules to all transferred intangibles upon the sale of a business.[19]

II. GOVERNMENT GOODWILL HUNTING BEFORE 1993

As background, this Part explores the government's goodwill-hunting quest prior to the 1993 adoption of § 197. Taxpayers generally minimized goodwill allocations on business acquisitions prior to 1993 in order to increase their depreciation deductions. By providing the same fifteen-year depreciation period for all covered intangibles, the 1993 enactment of § 197 alleviated pressure on goodwill allocations. After section II.A expands upon this general description, section II.B provides two illustrative examples.

A. General Description of Pre-1993 Dynamic and § 197

When a taxpayer purchases a business, the taxpayer must allocate the purchase price among all the acquired assets.[20] This allows separate determinations of depreciation for each acquired asset as well as any gain (or loss) on the subsequent sale of any acquired asset. From an incentives standpoint, buyers generally prefer to allocate more purchase price to depreciable assets, especially ones with relatively

18. As discussed *infra* notes 165–69 and accompanying text, further issues support this proposed deletion of trademarks from § 1253. In contrast to franchises, § 1253 now presents a very unbalanced approach to the two sides of the trademark transaction, which further incentivizes taxpayer goodwill allocations. Linking to the textual legislative history point, this also raises questions regarding the propriety of such taxpayer-adverse rules.

19. As discussed *infra* note 30 and accompanying text, § 197 applies most strongly in the context of a trade or business context. For instance, § 197 does not apply to certain separately acquired assets. I.R.C. § 197(e)(4) (2012).

20. I.R.C. § 1060(a) (2012) ("In the case of any applicable asset acquisition, for purposes of determining both—(1) the transferee's basis in such assets, and (2) the gain or loss of the transferor with respect to such acquisition, the consideration received for such assets shall be allocated among such assets acquired in such acquisition . . . ."). The § 1060 approach is consistent with the classic *Williams v McGowan* case, which held that the sale of a business should be treated as the sale of the underlying assets rather than the sale of a single "capital asset" business. 152 F.2d 570, 572 (2d Cir. 1945).

short depreciation periods.[21] This allows faster depreciation deductions, which reduces the reportable income (and tax payments) in the short term. Such quicker cost recovery generally benefits taxpayers under time-value-of-money principles. As evidenced by the short example right below, earlier tax savings benefit taxpayers through reducing their interest expense in the interim period.[22]

Assume that Bob Buyer pays tax at a constant 50% rate each year and buys a $1,000,000 asset. With a five-year depreciation period, Bob will save $100,000 tax in each of the next five years.[23] A longer ten-year period reduces Bob's annual tax savings to just $50,000.[24] In this case, Bob would recoup the initial annual $50,000 shortfall through an additional $50,000 savings in years six through ten. But the shorter five-year period allows a greater reduction to Bob's borrowings in the early years, thereby reducing his interest expense.[25] Finally, a nondepreciable asset generally would provide even worse treatment as its cost does not generate any depreciation deductions at all. Rather, the purchase price serves only as an offset against sales proceeds on a subsequent sale.[26]

On the other hand, the government generally benefits from the delayed recovery of acquisition costs. Such cost-recovery deferral generates earlier tax collections, with the corollary reduction of governmental interest expense in the interim. As such, prior to 1993, the government often allocated significant purchase price to nondepreciable goodwill. As noted above, any allocable goodwill cost served solely to offset sales proceeds on a subsequent sale in the future. As a quick

21. Section 167 looks to the actual useful life for the cost recovery period for intangible assets. *See supra* note 2. In contrast, § 168 provides special recovery periods for tangible assets, which can deviate from the actual useful lives. I.R.C. § 168(a)(2), (c) (2012).
22. And if the taxpayer already does not need to borrow at all, the tax savings could be invested in the interim period, generating interest income. As this assumes constant tax rates, note that a meaningful tax rate increase in the later year(s) could reverse the results such that an earlier payment would be more advantageous notwithstanding the time value of money.
23. The amount of $1,000,000 total cost recovered evenly over five years equals a $200,000 depreciation deduction each year. And a $200,000 depreciation deduction each year would save the taxpayer $100,000 of taxes each year given the taxpayer's constant 50% tax rate. Hence, $200,000 reduced income (via the deduction) times the 50% rate equals $100,000.
24. The amount of $1,000,000 total cost recovered evenly over ten years equals a $100,000 depreciation deduction each year. And a $100,000 depreciation deduction each year would save the taxpayer $50,000 of taxes each year given the taxpayer's constant 50% tax rate. Hence, $100,000 reduced income (via the deduction) times the 50% rate equals $50,000.
25. Again, if they do not have interest expense, they can then invest the savings in the interim period and receive interest income.
26. As a technical matter, the taxpayer receives a cost "basis" in the asset. I.R.C. § 1012 (2012). And when the asset is sold, such basis offsets the "amount realized." I.R.C. § 1001 (2012).

aside, note that the government similarly benefited from allocations to going concern value. While goodwill and going concern value closely relate, the court in *Canterbury v. Commissioner* distinguished the two concepts as follows: goodwill captures the "business reputation and the strength of customer loyalty," while going concern value reflects more "the operating relationship of assets and personnel inherent in an ongoing business."[27]

These conflicting incentives lead to tremendous litigation over the years, with taxpayers claiming over a hundred different intangible assets separate from goodwill and going concern value.[28] In response to all protracted litigation and difficulties in resolving the thorny goodwill-related issues, Congress enacted § 197 in 1993.[29] On the acquisition of a trade or business,[30] most acquired intangibles now qualify for fifteen-year depreciation regardless of their actual useful life. The covered § 197 intangibles importantly include not only goodwill and going concern value but many other goodwill-related assets like trademarks, franchises, and patents.[31] As such, § 197 has largely rendered moot the thorny buyer-side allocation issues between goodwill and related intangible assets.[32]

Finally, note the comparable treatment of goodwill, franchise, and trademark costs to buyers even before the adoption of § 197. Trademark and franchise costs also generally failed to generate any depreciation prior to § 197 given the lack of a defined useful life. As such,

27. *See* Canterbury v. Comm'r, 99 T.C. 223, 252 (1992).

28. This is reflected in the preamble to the recent § 367 regulations. *See* Treatment of Certain Transfers of Property to Foreign Corporations, 81 Fed. Reg. 91,012, 91,014–15 (Dec. 16, 2016).

29. *Id.* For additional background discussion, see Mary LaFrance, *Days of Our Lives: The Impact of Section 197 on the Depreciation of Copyrights, Patents and Related Property*, 24 HOFSTRA L. REV. 317, 321–24 (1995).

30. While § 197 can apply to certain assets acquired separately apart from a trade or business, separately acquired patents and copyrights fall outside § 197. *See* I.R.C. § 197(e)(4) (2012).

31. For a fuller listing of § 197 intangibles, see *infra* notes 98–100 and accompanying text.

32. The loss-disallowance rule of § 197(f) provides protection for the government. Without a loss-disallowance rule, taxpayers would have an incentive to allocate extra basis to intangibles they plan to sell shortly after the acquisition in order to then claim a loss on such sale. Section 197(f) neatly blocks that incentive by disallowing any such claimed loss (and reallocating the basis to the other retained intangible assets). Some smaller planning opportunities nonetheless remain, though, including the incentive to: (1) allocate more to assets which might be sold off separately to protect against gain on such subsequent sale (if the asset does not lose value as quickly as the § 197 depreciation) and (2) allocate less to capital assets which might be sold off separately to generate extra low-rate capital gains, with extra basis on the remaining intangibles generating ordinary-rate deductions over time.

taxpayers generally did not allocate purchase price away from goodwill and towards trademarks or franchises.[33]

B. Two Illustrative Examples

To illustrate the above points, consider the following two examples.

1. *Example 1: Former Baseball Commissioner Bud Selig's Tax Case*

Consider Bud's 1970 purchase of the Brewers baseball team before his stint as Baseball Commissioner.[34] Bud allocated almost ninety-five percent of the $10,800,000 purchase price to player contracts with a five-year depreciation period.[35] Bud allocated a much smaller five percent to the baseball's team's nondepreciable franchise.[36] The government challenged the low franchise percentage, but the court upheld Bud's allocation.

Consider now the key takeaways from this classic case. First, and most importantly, § 197 now neatly resolves the litigated issue as costs for either the player contracts or the franchise qualify for the same fifteen-year depreciation. In addition, § 197 also preserves the prior neutrality between the previously nondepreciable assets like goodwill, going concern value, and trademarks.[37] Now, however, all those assets likewise receive the same fifteen-year depreciation as

33. There were some exceptions to this general rule. See, for example, the discussion of the original § 1253(d) prior to amendment *infra* notes 165–69 and accompanying text. *See also* Herrick v. Comm'r, 85 T.C. 237, 266 (1985) ("Prior to the enactment of section 1253(d)(2) . . . [t]he deductibility or amortization of payments in connection with the acquisition of franchises depended upon whether the franchise had a reasonably determinable useful life." (citations omitted)); S. Rep. No. 91-552, at 208, 210 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 2027, 2242, 2245 ("Under present law, amounts paid (initial fees or contingent payments) to acquire a franchise, trademark, or trade name may not be deducted by the transferee through depreciation or amortization, since franchises, trademarks, and trade names are considered to be intangible assets with unascertainable useful lives. . . . Of course, the franchise, trademark, or trade name may have an ascertainable life in the circumstances of a particular case.).

34. Selig v. United States, 740 F.2d 572 (7th Cir. 1984). At the time of acquisition, the team was based in Seattle (and named the Pilots). *Id.* at 574–75.

35. This amount would be $10,200,000 of the $10,800,000. *Id.* at 575.

36. A sum of $500,000 of the $10,800,000 was allocated to the franchise. The remaining $100,000 (a relatively insignificant one percent) was allocated to tangible assets such as equipment. *Id.*

37. As discussed *infra* notes 165–69 and accompanying text, § 1253(d) provided two possible deduction scenarios for trademarks prior to amendment in connection with the 1993 enactment of § 197. Neither scenario would have been applicable on these facts. As discussed *infra* notes 157–61, the two categories involved either the retention of a significant right or contingent payments.

player contracts (and franchises).[38] So just like the actual case, there is no need to undertake possible tricky distinctions between franchise,[39] goodwill, going concern value, and trademarks.[40]

To develop a fuller range of issues,[41] the next example extends Bud's actual tax case to a fictional restaurant and brewery.

2. *Example 2: Sale of Bud's Bar & Grill*

Assume now that Bud financed his Brewers acquisition by selling his restaurant and brewery, named Bud's Bar & Grill. In addition to tangible real estate and inventory, Bud's Bar & Grill owns the following intangible assets: (1) trademarks on several varieties of home brews;[42] (2) copyrights on menus, a monthly newsletter, a website, and a restaurant recipe book;[43] (3) patents on certain recipes; (4) cer-

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38. I.R.C. § 197(d)(1)(A) (2012) ("goodwill"); *id.* § 197(d)(1)(B) ("going concern value"); *id.* § 197(d)(1)(C)(i) ("workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment"); *id.* § 197(d)(1)(F) ("franchise, trademark"). In addition, note that subsequent contingent payments are depreciated over the remaining years on the original fifteen-year timetable. Treas. Reg. § 1.197-2(f)(2) (2013).

39. For an analysis of whether goodwill can be separated from a franchise, see *infra* notes 79–81 and accompanying text.

40. While the actual case did not mention any trademarks, a current sale of the Brewers would involve some trademark value, such as for the "BrewCrew" moniker. *See Brew Crew*, TRADEMARKIA, http://www.trademarkia.com/brew-crew-77493165.html [http://perma.unl.edu/7N8X-AYQV].

41. This example removes the franchise aspect, which will be particularly helpful for Part III. As developed therein, franchises can dodge certain issues by subsuming all the business goodwill. *See infra* notes 79–81 and accompanying text. For actual cases dealing with breweries see, for example, *Seattle Brewing & Malting Co. v. Commissioner*, 6 T.C. 856, 868, 873 (1946) (holding that the grant of trade name for a limited geographic region constituted a sale for tax purposes), and *Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930) (denying taxpayer loss of goodwill deduction upon prohibition).

42. See, for example, BJ'S RESTAURANTS, INC., FORM 10-K (2013), https://www.sec.gov/Archives/edgar/data/1013488/000119312513074282/d447638d10k.htm#toc447638_24 [https://perma.unl.edu/G8TS-C5SL], for a sample of a restaurant's trademarks:

> Our domestically-registered trademarks and service marks include, among others, the word mark "BJ's Chicago Pizzeria," and our stylized logo, displaying the name "BJ's." In addition, among others, we have registered the word marks "BJ's Restaurant & Brewery," "BJ's Restaurant & Brewhouse" and "BJ's Pizza & Grill" for our restaurant services; "Harvest Hefeweizen," "BJ's Jeremiah Red," "BJ's P.M. Porter," "Brewhouse Blonde," "Owen's IPA," "Pooks," "Piranha," "NitWit," "Nutty Brewnette," "Tatonka" and "Berry Burst Cider" for our proprietary beers . . . ."Harvest Hefeweizen," "BJ's Jeremiah Red," "BJ's P.M. Porter," "Brewhouse Blonde," "Owen's IPA," "Pooks," "Piranha," "NitWit," "Nutty Brewnette," "Tatonka" and "Berry Burst Cider" for our proprietary beers."

43. For a discussion of possible copyright on a recipe book, see Betty Wang, *Can You Copyright a Recipe?*, FINDLAW (June 7, 2013), http://blogs.findlaw.com/law_and_life/2013/06/can-you-copyright-a-recipe.html [http://perma.unl.edu/GC5M-

tain unpatented recipes protected as trade secrets;[44] (5) customer lists for the monthly newsletter;[45] and (6) unspecified goodwill and going concern value.[46] Buddy Buyer pays $10,800,000 for Bud's Bar & Grill's assets.

Consider now the key takeaway from this more robust example. Prior to § 197, Buddy Buyer would have had an incentive to allocate away from goodwill and towards a number of other assets, such as the customer lists, patents, or copyrights (all of which qualified for depreciation prior to § 197).[47] There would be a further incentive to allocate towards assets with shorter lives than longer lives, such as more to the patent and less to the copyright.[48] Once again, though, § 197 neatly resolves all these allocation difficulties as each of the acquired intangibles now qualifies for the same fifteen-year depreciation.[49]

C. Summary

In sum, § 197's very broad coverage now generally negates the need to separate out short-lived intangible assets from goodwill. Section 197 also preserves the general lack of any need to separate out goodwill from trademarks and franchise value.[50] But as Part III demonstrates, these thorny issues remain when the focus shifts from the buyer to the seller. As developed therein, several other Code sections

QBFR]. And for a restaurant example, see JUDY RODGERS, THE ZUNI CAFE COOKBOOK: A COMPENDIUM OF RECIPES AND COOKING LESSONS FROM SAN FRANCISCO'S BELOVED RESTAURANT (2002).

44. For the ability to protect certain recipes under patent law (and the more general trade secret possibility), see *Can Recipes Be Patented?*, INVENTORS EYE (June 2013), https://www.uspto.gov/custom-page/inventors-eye-advice-1 [http://perma.unl.edu/7KL6-7AQX].

45. For a restaurant's balance sheet showing various intangibles, including customer lists, trademarks, and goodwill, see, for example, LANDRY'S RESTAURANTS, INC., FORM 10-K (2011), https://www.sec.gov/Archives/edgar/data/908652/000119312511068593/d10k.htm [https://perma.unl.edu/PJ7N-8J4R].

46. For a restaurant's balance sheet showing goodwill, see, for example, *id.*

47. Similar to the player contracts in the actual Bud Selig case, there also would be an incentive to allocate to workforce in place. There would be a further incentive to allocate towards assets with shorter lives than longer lives. See *supra* text accompanying notes 23–26.

48. Patents generally have a shorter useful life than copyrights given the shorter legal time of protection. *See, e.g.*, Xuan-Thao N. Nguyen & Jeffrey A. Maine, *Taxing the New Intellectual Property Right*, 56 HASTINGS L.J. 1, 13 (2004).

49. I.R.C. § 197(d)(1)(A) (2012) ("goodwill"); *id.* § 197(d)(1)(B) ("going concern value"); *id.* § 197(C)(iii) ("any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item"); *id.* § 197(d)(1)(C)(iv) ("any customer-based intangible"); *id.* § 197(d)(1)(F) ("trademark").

50. If anything, § 197 actually further cleaned up this area and provided some potential exceptions to the general lack of depreciation for franchises and trademarks. *See supra* note 33.

interestingly encourage selling taxpayers to allocate consideration *towards* goodwill.[51]

III. GOODWILL HUNTING GONE BAD: TAXPAYERS NOW HUNT

As highlighted above, § 197 generally negates the buyer's incentive to downplay goodwill.[52] But as discussed in this Part, other Code sections perversely incentivize taxpayers to overstate goodwill. Recent regulations highlight such opportunistic behavior by U.S. corporations on transfers to foreign subsidiaries.[53] While the recent tax bill shuts this down, Section III.A will explore these subsidiary transfers since the lessons from these related-party transfers link to similar, unaddressed incentives on business sales to unrelated third parties. Sections III.B and III.C demonstrate such linkage as regards foreign tax credits and lower capital gains rates, respectively.[54]

A. Goodwill Hunting on Transfers to Foreign Subsidiaries

As background, consider first a brief description of §§ 351 and 367. Section 351 generally allows tax-free transfers of appreciated property to domestic subsidiaries since a fully taxable U.S. company continues to hold the transferred assets.[55] In contrast, § 367(a) generally overrides this tax-free result for transfers to foreign subsidiaries since the assets are no longer held by a fully taxable U.S. company.[56] Section 367(a) contains a tax-free exception for qualified "active trade or business" property.[57] If such exception does not apply, § 367(a) generally requires a single payment keyed to the transferred assets' value.[58] But due to the difficulty in valuing intangible assets, § 367(d) imposes instead an annual deemed royalty on enumerated intangibles keyed to the actual profits over time (a so-called super royalty).[59]

51. References to "goodwill" include both goodwill and the closely related going concern value.
52. *See supra* section II.A.
53. *See*, *e.g.*, Treatment of Certain Transfers of Property to Foreign Corporations, 81 Fed. Reg. 91,012, 91,014–15 (Dec. 16, 2016).
54. As developed in section III.B, the specific international issue involves foreign tax credits. Section III.C considers more general capital gain provisions, which can be applicable to either domestic or international sales.
55. As discussed *infra* note 66, the recent tax bill created a new "territories" system for domestic corporations and foreign subsidiaries.
56. While repatriations from the foreign subsidiary would face U.S. tax, concern over indefinite deferrals of tax lead to this section. See *supra* text accompanying notes 23–26.
57. I.R.C. § 367(a)(3) (2012).
58. More technically, the taxed gain would equal the asset's value less its basis. I.R.C. § 1001 (2012).
59. Note that § 367(d) was first added in 1984 with just a regular deemed royalty. The super royalty aspect was added in 1986. *See* STAFF OF JOINT COMM. ON TAXA-

Consider next the § 367 connection to goodwill hunting.[60] Section 367(d) defines the covered intangibles by cross-reference to § 936(h). Prior to the recent tax bill, § 936(h) did not explicitly reference goodwill. In addition, consistent with the legislative history, the initial 1986 regulations excluded goodwill from § 367(a) and (d).[61] Linking back to Part II, the preamble to the current § 367 regulations explain how

> taxpayers have reversed their positions regarding the significance of goodwill and going concern value in response to the enactment of sections 197 and 367(d), and now commonly assert that such value constitutes a large percentage—even the vast majority—of an enterprise's value [in order to avoid gain recognition under § 367].[62]

To illustrate, recall the earlier second example involving Bud's Bar & Grill.[63] This sale involved a number of intangible assets: trademarks, copyrights, patents, trade secrets, customer lists, and generalized goodwill. Assume now that Bud had a second London restaurant and decided to transfer his overseas operations to a U.K. subsidiary. As § 367(d) explicitly included all the intangibles other than goodwill

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TION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1013–16 (Comm. Print 1987) ("There was a strong incentive for taxpayers to transfer intangibles to related foreign corporations . . . in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers could result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group. . . . In making this change [to the super royalty], Congress intended to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor payment for related party intangibles transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms. . . . Congress did not intend however that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. Congress intended that consideration also be given to the actual profit experience realized as a consequence of the transfer. Thus Congress intended to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible. The act is not intended to require annual adjustments when there are only minor variations in revenues. However, it will not be sufficient to consider only the evidence of value at the time of the transfer. Adjustments will be required when there are major variations in the annual amounts of revenue attributable to the intangible.").

60. For another commentator's use of "goodwill hunting," see, for example, Brett Wells, *Revisiting Section 367(d): How Treasury Took the Bite Out of Section 367(d) and What Should Be Done About It*, 16 FLA. TAX REV. 519, 523 (2014) ("THE GOODWILL HUNTING EXERCISE CAUSED US TO LOSE FOCUS ON SECTION 367(d)'S OBJECTIVE").
61. *See, e.g.*, Treatment of Certain Transfers of Property to Foreign Corporations, 81 Fed. Reg. 91,012, 91,013–14 (Dec. 16, 2016).
62. *Id.* at 91,015.
63. *See supra* subsection II.B.2. As will be explained more fully in the next section, I utilize the second example since the franchise aspect in the first example might negate any severable goodwill. *See*, *e.g.*, *infra* note 81 and accompanying text.

prior to the recent change, Bud might have attempted a significant goodwill allocation instead.

The recent tax bill expanded the intangibles definition to include goodwill and going concern value.[64] These § 367 difficulties nonetheless remain instructive given the linkage to goodwill incentives in comparable contexts. In this regard, consider the following key language from the current regulation's preamble:

> The IRS's experience administering section 367(d) has, once again, highlighted the abuse potential that arises from the need to distinguish value attributable to nominally distinct intangibles that are used together in a single trade or business. *Specifically, the uncertainty inherent in distinguishing between value attributable to goodwill and going concern value and value attributable to other intangible property makes any exception to income recognition for the outbound transfer of goodwill and going concern value unduly difficult to administer and prone to tax avoidance.* Of course, any rule that provides for the tax-free transfer of one type of property, while the transfer of other types of property remains taxable, provides an incentive to improperly allocate value away from the taxable property and onto the tax-free property. *This problem is acute, however, in cases involving the offshore reorganization of entire business divisions that include high-value, interrelated intangibles, because goodwill and going concern value are particularly difficult to distinguish (perhaps are even indistinguishable) from the enumerated section 936 intangibles.*[65]

B. Goodwill Hunting for Foreign Tax Credits

As background, consider first the linkage of foreign tax credits to income sourcing (U.S. versus foreign). Even though the United States generally taxes all income of U.S. taxpayers,[66] sourcing can impact the final tax bill due to foreign income tax credits. To alleviate the double taxation of foreign-source income, § 904(a) allows U.S. taxpayers a foreign-income tax credit against their U.S. tax, subject to the following limitation: "The total amount of the credit . . . shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United

64. Section 14221 of the Tax Cuts and Jobs Act revised part (vi) of the cross-referenced § 936(h)(3)(B). Pub. L. No. 115-97, § 14221, 131 Stat. 2054, 2218 (to be codified in scattered sections of 26 U.S.C.). Note that a prior version of this article (drafted before the tax bill) proposed such a change.

65. *See, e.g.*, Treatment of Certain Transfers of Property to Foreign Corporations, 81 Fed. Reg. 91,012, 91,015 (Dec. 16, 2016) (emphasis added).

66. The recent tax bill created a new "territorial" system, subject to exceptions, for foreign corporations and certain foreign subsidiaries. To the extent applicable, this would negate this area of foreign tax credits. A fuller discussion of this new system is well beyond the limited scope of this paper. See I.R.C. § 245A (Supp. 2017), added by section 14101 of the Tax Cuts and Jobs Act. In contrast, foreign taxpayers are taxed only on their U.S.-source income. I.R.C. §§ 871(a), 881(a) (2012).

States bears to his entire taxable income for the same taxable year."[67] As illustrated right below, additional foreign-source income therefore increases the allowable credit.

To illustrate, assume a corporate taxpayer reports $1,000,000 of net income and paid $340,000 foreign income tax. Before the foreign tax credit, the U.S. tax liability equals $340,000 (determined at the 34% general corporate rate).[68] Assuming all foreign-source income, the corporation can fully use its foreign tax payments to avoid any U.S. tax payments.[69] With any U.S.-source income, however, the corporation cannot use all its foreign taxes paid as an offset. Assume, for instance, an equal split of U.S.- and foreign-source income. This would reduce the usable tax credit to just $170,000 (i.e., half the tax bill),[70] leaving $170,000 payable to the U.S. government.[71]

Consider next the sourcing rules for gain on the sale of intangibles by a U.S. taxpayer. Gains from covered intangible assets generally are sourced to the United States.[72] Section 865(d)(2) defines such intangibles as "any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property."[73] Section 865(d)(3), however, provides a special rule sourcing gain from the sale of goodwill to the country of origination.[74] This special rule eerily resembles the now-discredited § 367 exemption for goodwill. By likewise providing more beneficial treatment to goodwill, § 865(d)(3) encourages U.S. business sellers to boost goodwill allocations. If sus-

67. I.R.C. § 904(a) (2012). Note that there are more specific limitations, such as for passive income. *See* I.R.C. § 904(d)(1)(A) (2012). Specific limitations will be discussed in greater detail *infra* notes 139–42 and accompanying text.

68. *See* I.R.C. § 11 (2012).

69. If so, the allowable percentage would equal 100% ($1,000,000 foreign source divided by $1,000,000 total income). One hundred percent times the $340,000 U.S. tax (determined without regard to the credit) equals an allowable credit of $340,000. An allowable credit of $340,000 would bring the final U.S. tax payment down to zero: $340,000 initial payment less the allowable credit of $340,000 equals zero.

70. This would reduce the allowable percentage to 50% ($500,000 foreign source divided by $1,000,000 total income). Fifty percent times the $340,000 U.S. tax (determined without regard to the credit) equals an allowable credit of $170,000.

71. This would equal $340,000 initial tax less the $170,000 credit.

72. Section 865 states that income is sourced at the seller's residence (i.e., the U.S. for a U.S. taxpayer). I.R.C. § 865(a), (d)(2) (2012). There are two key exceptions to this general rule. First, payments "contingent on the productivity, use, or disposition of the intangible" are sourced to where the intangibles are used (the same as royalties). *Id.* §§ 865(d)(1)(A)–(B), 861(a)(4), 862(a)(4). Second, to the extent that prior depreciation was taken on the intangible asset, gain is sourced to where the prior depreciation was taken. § 865(c)(1), (d)(4)(A).

73. § 865(a).

74. Again, this assumes that the payments are not contingent. §§ 865(d)(1)(B), 861(a)(4), 862(a)(4). The special depreciation rules do not seem to apply to goodwill covered by § 865(d)(1), (3).

tainable, such allocation increases the reported foreign-source income and hence the allowable foreign tax credits.

The *International Multifoods Corp. v. Commissioner* case[75] neatly illustrates the goodwill-hunting quest. It also provides some necessary judicial gloss on the statute given the confusing inclusion of goodwill in both § 865(d)(2) and (d)(3), as described above. In the case, the U.S. taxpayer sold its Asian and Pacific operations of the Mister Donut franchise chain, including all existing franchise agreements, trademarks, secret formulas, processes, supplier agreements, etc. (essentially the entire "Mr. Donut System" for that area).[76] With an eye on its foreign tax credit, the taxpayer allocated 54% of the roughly $2,000,000 sales price to goodwill, another 40% to a noncompete covenant (likewise sourced as foreign[77]), with only 6% to the U.S.-sourced trademarks. The following language from a memo prepared by the taxpayer's employee captures the essence of the problem:

> In negotiating the allocation it is important to note that the amounts allocated to goodwill and the noncompete covenant, to the extent upheld upon IRS audit, will be tax-free [due to foreign tax credits]. The amount allocated to the trademarks and pending trademark applications will be subject to a tax of approximately 38% in the U.S. and potentially additional taxes in the countries in which such trademarks are registered. Therefore, to the extent that we can maximize the allocation to the goodwill and non-compete covenant, we will maximize Multifoods' after-tax gain on the sale.[78]

The tax court shut down this particular goodwill-hunting attempt, relying heavily upon the franchise aspect of the case.[79] In particular,

75. 108 T.C. 25 (1997).

76. *Id.* The franchise agreements described the "Mister Donut System" as:

> [T]he name "Mister Donut", a unique and readily recognizable design, color scheme and layout for the premises wherein such business is conducted (herein called a "Mister Donut Shop") and for its furnishings, signs, emblems, trade names, trademarks, certification marks and service marks . . . , all of which may be changed, improved and further developed from time to time . . . .
>
> The Mister Donut System also included methods of preparation, serving and merchandising doughnuts, pastries, and other food products, and the use of specially prepared doughnut, pastry, and other food product mixes as may be changed, improved, and disclosed to persons franchised by petitioner to operate a Mister Donut shop.

Id. at 28.

77. *Id*. at 48 ("[The government] concedes that the amount allocable to the covenant not to compete constitutes foreign source income . . . .").

78. *Id.* at 35.

79. Importantly, while the court focused at times on the goodwill associated with the trademarks, the quoted language in the text highlights the key centrality of the broader franchising system. Separately, the court also emphasized the inclusion of goodwill in § 865(d)(2) as well as § 865(d)(3):

> [W]e believe that Congress' enumeration of goodwill in section 865(d)(2) as a separate intangible asset necessarily indicates that the special sourcing rule contained in section 865(d)(3) is applicable only where goodwill is separate from the other intangible assets that are specifically

the broader franchise subsumed any and all of the business goodwill, thereby negating any stand-alone foreign-source goodwill:

> Petitioner transferred . . . all its rights to exclusive use in the designated Asian and Pacific territories of its secret formulas, processes, trade-marks, and supplier agreements; i.e., its *entire Mister Donut System*. . . .
>
> . . . .
>
> While there are no cases on point under section 865, case law interpreting other provisions of the Code supports respondent's position. In *Canterbury v. Commissioner*, we . . . recognized that McDonald's franchises encompass attributes that have traditionally been viewed as goodwill. . . .
>
> . . . .
>
> > The right to use the *McDonald's system*, trade name, and trademarks is the essence of the McDonald's *franchise*. . . . Respondent did not identify, and we cannot discern, any quantifiable goodwill that is not attributable to the *franchise.* We find that petitioners acquired no goodwill that was separate and apart from the goodwill inherent in the *McDonald's franchise*. . . .
> >
> > [*T*]*he franchise acts as the repository for goodwill*. . . .
>
> We concluded that the goodwill produced by the McDonald's system was embodied in, and inseverable from, the McDonald's *franchise* that the taxpayer received. . . .
>
> . . . .
>
> [Likewise here,] Petitioner's business in the operating countries was conducted by granting Mister Donut franchises. . . . The franchisees in the operating countries possessed the exclusive right to open stores *pursuant to established conditions* and at locations approved by the franchisor. In order to ensure that the distinguishing characteristics of Mister Donut were uniformly maintained, *the franchise agreements had established standards* for furnishings, equipment, product mixes, and supplies, which the franchisees were required to meet. *The franchise agreements also required that franchisees operate their shops in accordance with uniform standards of quality, preparation, appearance, cleanliness, and service*. . . .
>
> *Mister Donut's success resulted from the Mister Donut System* and the high standards for quality and service, which the franchisees were required to meet.[80]

As a general proposition, the Tax Court thus held that § 865(d)(3) applies only where the foreign goodwill can be separated from the other enumerated intangibles under § 865(d)(2). And in this particular

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> listed in section 865(d)(2). If the sourcing provision contained in section 865(d)(3) also extended to the goodwill element embodied in the other intangible assets enumerated in section 865(d)(2), the exception would swallow the rule. Such an interpretation would nullify the general rule that income from the sale of an intangible asset by a U.S. resident is to be sourced in the United States.

Id. at 37–38.

80. *Id.* at 40–43 (sixth and eighth omissions in original) (first, second, third, fourth, fifth, seventh, eighth, ninth, tenth, and eleventh emphases added) (internal quotations omitted) (citing Canterbury v. Comm'r, 99 T.C. 223 (1992)). As discussed in the next section, *Canterbury* involved § 1253, a special section covering franchises, trademarks and trade names. Given the very different legislative histories developed in that section, one might question whether the court gave too much weight to the prior *Canterbury* decision.

case, the taxpayer failed that requirement due to the Mister Donut franchise, which subsumed the entire business goodwill.[81]

While *International Multifoods* rejected the taxpayer's goodwill attempt, foreign-sourcing opportunities remain outside the franchise context.[82] The two prior illustrative examples will demonstrate this franchise dividing line.

1. *Example 1A: Bud Selig's Tax Case*

Recall how Bud Selig purchased the Brewers baseball franchise for $10,800,000 and allocated 95% to player contracts, with 5% to the franchise. The tax administrators argued for a higher allocation to the franchise. To engage the new sourcing material, assume now that the baseball team is the Yomiuri Giants: i.e., "the New York Yankees of Japan," given their large number of championships and huge popularity.[83]

As discussed in Part II, the buyer Bud Selig fought the tax administrators solely over the franchise and player-contracts values.[84] But at least prior to *International Multifoods*, the seller would have an additional goodwill incentive under § 865(d)(3), especially given the

81. *See, e.g.*, RUFUS VON THULEN RHOADES & MARSHALL J. LANGER, U.S. INTERNATIONAL TAXATION AND TAX TREATIES § 14.03 (Matthew Bender ed. 2017).

82. The court gave significant focus to the franchise aspect. *See supra* text accompanying note 80.

83. Mike Axisa, *Three Executives Resign as Yomiuri Giants Rocked by Gambling Scandal*, CBS SPORTS (Mar. 9, 2016), https://www.cbssports.com/mlb/news/three-executives-resign-as-yomiuri-giants-rocked-by-gambling-scandal [http://perma.unl.edu/6VEW-83LV].

84. The case did not engage in distinctions between franchise and goodwill value given the comparable treatment of these two intangibles to the buyer. *See supra* notes 38–40 and accompanying text.

team's popularity.[85] The *International Multifoods* decision might, however, dissuade such attempt given the franchise context.[86]

Given *International Multifoods'* focus on the Mr. Donut franchise, consider now the restaurant example.[87]

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85. While a player's contract allocation also would seem to generate foreign-source income, a goodwill attempt under § 865(d)(3) would protect against an IRS challenge to an oversized allocation to such player contracts. In this regard, the § 865(d)(2) listed intangibles do not mention workforce in place. *Cf.* I.R.C. § 197(d)(1)(C)(i) (2012) (explicitly mentioning workforce in place). Thus, assuming § 865(d)(2) does not apply (as discussed below), any depreciation recapture would be sourced as above with the remaining gain sourced like inventory at the place of sale (the place where the "rights, title and interest of the seller in the property are transferred to the buyer"). Treas. Reg. § 1.861-7(c) (1960); *see* I.R.C. §§ 865I(2), 861(a)(6), 862(a)(6) (2012). The government might try to push back in one of two ways. First, it might argue that the franchise also encapsulates player contracts. The earlier Bud Selig decision counteracts that approach, however. *See supra* notes 34–40 and accompanying text. Second, the government might argue that § 865(d)(2)'s residual "or other like property" includes workforce in place. In the somewhat similar § 367(d) context, prior to the recent regulations, the IRS asserted that the similar catchall in § 936 covered workforce in place. *See, e.g.*, Wells, *supra* note 60, at 552. Note that the final regulations do not take a position with respect to whether goodwill, going concern value, or workforce in place are § 936(h)(3)(B) intangibles but rather give the taxpayer a choice between the § 367(a) and 367(d) regimes. *See* DELOITTE, FINAL SECTION 367(A)/(D) REGULATIONS RETROACTIVELY PREVENT TAX-FREE OUTBOUND TRANSFERS OF FOREIGN GOODWILL AND GOING CONCERN VALUE nn.1, 6 (2016), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-united-states-367-20-december-2016.pdf [http://perma.unl.edu/8BJF-C8EX]. Unlike the § 367(d) context, however, an expansive reading of § 865(d)(2) seemingly contradicts the statute (at least as to goodwill) as § 865(d)(3) clearly contemplates foreign sourcing from the sale of foreign goodwill. In addition, § 865 is more narrowly drawn than the broader § 936, which has many more enumerated intangibles. *See supra* note 97 and accompanying text.
86. A taxpayer nonetheless might forge ahead on grounds that a baseball franchise differs from the donut franchising operations in *International Multifoods*. Alternatively, a taxpayer might take into account the fact that *International Multifoods* is just a lower court decision. See also *Sourcing Goodwill Separately from Other Intangibles*, CBIZ (Dec. 27, 2012), https://www.cbiz.com/insights-resources/details/articleid/1404/sourcing-goodwill-separately-from-other-intangibles-article [http://perma.unl.edu/DWU5-VQPY] for one firm's view that subsequent authority under a different Code section (§ 1031) recognizes the separation of trademarks and undercuts the holding of *International Multifoods*. As discussed below, though, that subsequent authority involved trademarks without the enveloping franchise aspect. Thus, this viewpoint's persuasiveness strengthens outside the franchise context. Taking a step back, one might question the theoretic appeal of the *International Multifoods*' approach to franchises. As discussed *infra* text accompanying note 124, goodwill serves as a proxy for the foreign taxation of the intangibles gain. As a theoretic matter then, this suggests the appropriateness of foreign sourcing for goodwill even in the franchise context where such gain faces foreign taxation. *See infra* notes 135–40 and accompanying text.
87. Interestingly, § 865(d)(2) as originally enacted in 1986 did not include franchises. Franchises were added to the § 865(d)(2) list by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1012(d)(12), 102 Stat. 3342, 3499,

2. Example 2A: Bud's London Bar & Grill

Assume now that Bud Selig sells his London Bar & Grill for $10,800,000. The transfer again includes the following intangible assets: trademarks, copyrights, patents, trade secrets, customer lists, and goodwill.

In contrast to the last example, the lack of any encapsulating franchise emboldens the seller's goodwill-hunting position. Following *International Multifoods*, goodwill associated with any of the enumerated intangibles (such as the trademarks) seemingly would not qualify for the special § 865(d)(3) goodwill-sourcing rule. But goodwill unassociated with any listed intangibles (such as the customer lists) seemingly would qualify as foreign sourced.[88]

Especially given the close association of trademarks and goodwill,[89] consider further this important difference between trademark-associated goodwill and other goodwill. Drawing upon one commenta-

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apparently as the initial exclusion was an oversight. *See* STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1988 (H.R. 4333 AND S. 2238) 259 (Comm. Print 1988) (failing to explicitly mention this change, but discussing more generally "conforming amendments"); *see also* Harvey Dale, *Effectively Connected Income*, 42 TAX L. REV. 689, 718 n.179 (1987) ("New § 865(d)(2) contains a definition of 'intangible' which is virtually identical [to § 862(a)(4)], except for the omission of 'franchises.' That omission is particularly interesting because the very purpose of the § 865(d)(2) definition is to cross-refer to § 862(a)(4).").

88. Also, while not a goodwill-hunting point per se, a similar allocation problem remains to the extent that taxpayers attempt to establish value on the nonlisted assets themselves (rather than on the associated goodwill). The exclusion of customer lists from § 865(d)(2), in contrast to §§ 936 and 197, therefore encourages taxpayers to place value on unlisted assets like customer lists since they will receive the favorable result so long as the value is sustainable for either the asset itself or the associated goodwill. Compare *General Television, Inc. v. United States,* 449 F. Supp. 609, 611–12 (D. Minn. 1978), where the court distinguished depreciable customer lists separate from goodwill from nondepreciable customer lists inseparable from goodwill under the law prior to § 197:

> Therefore, because the subscriber contracts served primarily as a measure of the . . . systems' earning capacity and because goodwill is based primarily upon earning capacity, the court is of the opinion that to the extent that the intangible assets purchased by the plaintiff consisted of subscriber contracts those assets constituted goodwill.

Id. at 611. Emboldened taxpayers now can win without having to make such distinctions so long as their allocated valuations are sustainable.

89. This is evidenced by the fact that a valid trademark assignment must also include the goodwill. *See* Sands, Taylor & Wood Co. v. Quaker Oats Co., 978 F.2d 947, 956 (7th Cir. 1992) ("[T]he transfer of a trademark apart from the good will of the business which it represents is an invalid 'na'ed' 'r 'in gr'ss' assignme"t," which passes no rights to the assignee.") For some good case cites linking trademarks and goodwill, see, for example, LaFrance, *supra* note 29, at 334 n.67. For a general discussion of the role of goodwill in trademark law and the difficulties defining goodwill, see Robert G. Bone, *Hunting Goodwill: A History of the Concept of Goodwill in Trademark Law*, 86 B.U. L. REV. 547 (2006).

tor's project and terminology, "over-all goodwill" extends beyond the goodwill associated with a trademark.[90] This broader "over-all goodwill" concept also comports with other commentary and cases. For instance, one commentator contrasts the "goodwill associated with the mark [from] other business goodwill, i.e., arising from location, customer lists, favorable trading or governmental relationships, etc."[91] Another commentator notes a number of other assets which can contribute to goodwill along with trademarks: "goodwill . . . is dependent for its existence on other things such as a name, license, trademark, business contracts, know how, etc."[92] One court similarly has explained:

> The competitive advantage which comprises *goodwill is represented by a number of property rights* or interests, including [but not limited to] tradenames . . . , trademarks . . . , some customer lists . . . , customer routes and other distribution networks, and secret formulae or processes . . . .[93]

In addition, IRS authority in the § 1031 like-kind-exchange area[94] recognizes trademarks as just one component part of over-all goodwill

90. Megan Bartkowski, *Trademarks as Components of Goodwill,* 19 J. CONTEMP. LEGAL ISSUES 165, 166 (2010).
91. *See* Pamela Chestek, *Assigning "Goodwill"*, PROPERTY, INTANGIBLE (July 23, 2008), http://propertyintangible.com/2008/07/assigning-goodwill.html [http://perma.unl.edu/AG66-QLHE]. Another commentator similarly characterizes goodwill as capacious. Michael Grynberg, *Thick Marks, Thin Marks*, 67 CASE W. RES. L. REV. 13, 29 (2016) ("Goodwill is also a capacious concept. Positive consumer associations with COCA-COLA are partly due to the soda's combination of taste and cost, but they are also the product of advertising and experience. The hazy memory (or was it in a commercial?) of one's mother giving the sweet reward of a soda after a successful trip to the dentist is information created in large part by someone other than the trademark holder.").
92. Charles R. McManis, *Intellectual Property and International Mergers and Acquisitions*, 66 U. CINCINNATI L. REV. 1283, 1309 n.163 (1998); *see also* Marilyn Barrett, *Capital Gain Treatment on Sale of Intangible Assets*, 50 U.S.C. MAJOR TAX PLANNING 1004 (1998) ("A number of questions must be addressed to determine whether a taxpayer who sells intellectual property is entitled to capital gain treatment. These include: Can goodwill and going concern value be separated from transferred trademarks? Can the intangibles be split and the purchase price allocated between them?"). Several cases indicate that goodwill can be valued separately. *See* Int'l Multifoods Corp. v. Comm'r, 108 T.C. 25 (1997); *see also* I.R.S. Tech. Adv. Mem. 97-38-001 (May 2, 1997) (following *Hearst Corp. v. United States*, 13 Cl. Ct. 178 (1987), which held that the ability of a television station to affiliate with major networks is separate from affiliation with a particular network). Moreover, cases have not held that the ability to affiliate is inherent in the FCC license and this ability, along with other intangibles, are valued separately from the FCC license.
93. Philip Morris, Inc. v. Comm'r, 96 T.C. 606, 634 (1991) (emphasis added).
94. Section 1031 provides that taxpayers do not recognize gain (or loss) on the exchange of "like-kind" property (e.g., land for other land). I.R.C. § 1031 (2012). Under Treas. Reg. § 1.1031(a)-2(c)(2) (2005), however, goodwill exchanges cannot qualify for such nonrecognition. *See id.* ("The goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.").

and the typical ability to separate out trademark value from goodwill.[95] Consistent with the above analysis and illustrative examples, this authority importantly involved trademarks *outside* the franchise context.[96]

Finally, the much narrower list of § 865(d)(2) intangibles compared to §§ 936[97] and 197 further evidences the significant goodwill-hunting possibilities under § 865. Intangibles listed under § 936 but not § 865 include: any method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data. Intangibles listed under § 197 but not § 865 include: going concern value; workforce in place; business books and records, operating systems, or any other information base (including (customer) lists); any customer-based intangible;[98] any supplier-based intangible;[99] any license, permit, or other right granted by a governmental unit or an agency or

95. In a revised position, the Service acknowledged that trademarks could qualify for like-kind treatment notwithstanding a regulatory prohibition for like-kind exchanges on goodwill. Memorandum from Office of Chief Counsel, Internal Revenue Serv., to Joyce L. Sugawara, Media & Entm't Indus. Counsel (Mar. 13, 2009) ("Accordingly, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as like-kind property under § 1031. In our opinion, *except in rare and unusual situations*, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles can be separately described and valued apart from goodwill." (emphasis added)). Interestingly, note that even the Service's earlier position (which blocked like-kind treatment for trademarks) recognized the distinction between trademark value and overall goodwill. I.R.S. Tech. Adv. Mem. 2006-02-034 (Sept. 29, 2005) ("Trademarks and trade names are, we believe, a *component of a larger asset, either of goodwill*, or of going concern or both. . . . Since they are so closely related to (if not *a part of*) the goodwill and going concern value of a business, it is our view that trademarks and trade names should not be considered of like-kind under § 1031." (emphasis added)).

96. As noted above, this authority has in fact led one firm to call into question the *International Multifoods* anti-foreign sourcing approach. *See Sourcing Goodwill Separately from Other Intangibles*, *supra* note 86 ("If a case similar to the *International Multifoods* case were to arise today, after the issuance of CCA 200911006, the IRS could not make a consistent argument that the trademarks and franchises were inextricably related to goodwill and that the franchises and trademarks embody goodwill."). As discussed in the text, this viewpoint's persuasiveness is much stronger outside the franchise context.

97. *See* Dale, *supra* note 87, at 718 n.179 ("New § 865(d)(2) contains a definition of 'intangible' which is virtually identical . . . to § 862(a)(4) . . . . For a much longer list of 'intangible property,' compare § 936(h)(3)(B).").

98. This is defined as "composition of market, market share, and any other value resulting from future provision of goods or services pursuant relationships . . . in the ordinary course of business with customers." I.R.C. § 197(d)(2)(A)(i)–(iii) (2012).

99. This is defined as "any value resulting from future acquisitions of goods or services pursuant to relationships . . . in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer." § 197(d)(3).

instrumentality thereof; or any covenant not to compete.[100] In addition, § 865 lists *secret* formulas or processes, whereas both §§ 936 and 197 list process or formulas without the limiting *secret* qualifier. In sum, §§ 197 and 936 both highlight a very broad range of intangibles outside the scope of § 865(d)(2). Combined with § 865(d)(3), this heightens the goodwill incentives recently denounced by the § 367 regulations.

C. Seller's Goodwill Incentives for Capital Gains

As demonstrated in this section, a seller's goodwill incentives extend beyond foreign tax credits to the lower capital gains rates. As such, even domestic sales can generate goodwill-hunting mischief by sellers. In particular, higher goodwill allocations can increase the amount of low-rate capital gains. Goodwill's impact on the seller markedly deviates from § 197's goodwill neutrality on the buyer's side.[101] Subsection III.C.1 uncovers the most prominent issue involving contingent payments over time. Subsection III.C.2 then demonstrates some additional possibilities even for fixed amounts.

1. Contingent "Earn Outs"

Consider first contingent payments over time based on earnings. These so-called earn outs are used frequently in intellectual property transfers, especially given the valuation difficulties.[102] As developed below, these earn outs trigger adverse results to the seller under

100. As discussed *supra* note 77, the government conceded the foreign sourcing of the noncompete covenant in *International Multifoods*.

101. As discussed *supra* note 32, some more limited planning opportunities remain under § 197.

102. Daniel A. Izzo, *Contingent Payment Transfers of Trademarks: A Sale in License Clothing*, 12 VA. TAX REV. 263, 265, 276 (1992) ("[T]he use of contingent payments in trademark transfers is common. . . . The uncertain value of a patent or a trademark makes it reasonable for the parties to use a quasi-royalty arrangement. The value of a patent cannot be determined until the product is manufactured. If the product is successful, the patent was valuable; if the product flops, the patent was worthless. The same problem exists with trademarks. The value of a trademark cannot be easily ascertained until it is affixed to a product. If the sales of the product increase, the trademark is valuable. If sales do not increase, the trademark is valueless. Because the same 'inherent uncertainties' that exist in patent transfers exist in trademark transfers, contingent payments are equally reasonable in trademark transfers and patent transfers."); *see also* AM. APPRAISAL, EARN-OUTS AND CONTINGENT CONSIDERATION: VALUATION 1 (2013), http://www.american-appraisal.com/AA-Files/Library/PDF/Earn-outandContingentValuation.pdf [http://perma.unl.edu/57CX-YK3N] ("In M&A deals, it is common for part of the consideration to be contingent upon earnings performance over single or multiple periods. Such structures can help bridge the gap between the buyer's and seller's valuation and earnings expectations. They can also provide a cash flow benefit for the buyer since payments can be deferred until the company is performing at or above forecasts.").

§ 1253 if allocable to franchises or trademarks. Consider again the Bud Selig tax case, appropriately modified to expose this new aspect.

a. *Example 1B: Bud Selig's Tax Case*

In the actual case, Bud Selig purchased the Brewers baseball franchise for $10,800,000 fixed consideration with a 95% allocation to the player contracts. Assume now instead the following mixture of consideration: $5,400,000 payable at closing plus a contingent 10% of revenue for the next five years.

The buyer Bud would now get the same result under § 197 regardless of the allocation of the fixed or contingent payments to player-contracts, trademark, franchise, goodwill, or going concern values.[103] But the seller's results would vary significantly based on the allocation. Trademark or franchise allocations would trigger the higher ordinary income rates. Section 1253(c) automatically taints all contingent payments for "franchises, trademarks or tradenames" as ordinary income.[104] Section 1253(a) likewise treats the fixed payments as ordinary if coupled with "substantial" contingent payments.[105] In contrast, allocations to the player contracts, goodwill, and going concern value generally would qualify for the lower capital gains rates.[106] In sum, § 1253 maintains the difficult allocative distinctions erased on the buyer's side by § 197.[107]

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103. See *supra* note 38 for contingent payments.

104. The lack of capital gains for contingent payments might seem to make good sense as contingent payments might seem to be an indicator that the transaction really is a license (with ordinary royalty income) rather than a sale. *See infra* notes 151–56 and accompanying text (discussing § 1253 legislative history). But as brought out in the textual discussion, this ordinary tainting on franchises and trademarks is at odds with the treatment of contingent payments for other assets. In fact, as discussed in greater detail *infra* notes 158–59 and accompanying text, § 1253's approach on contingent assets directly conflicts with explicit authority for other intellectual property such as patents. *See* I.R.C. § 1235(a)(2) (2012); Rev. Rul. 60-226, 1960-1 C.B. 26. Perhaps more to the point, this selective tainting of only certain assets leads to taxpayer incentives to mischaracterize and tricky valuation disputes.

105. § 1253(a), (b)(2)(F). In *Nabisco Brands v. Commissioner*, the tax court held that contingent payments are substantial if they constitute twenty-five percent or more of the total estimated value received. 69 T.C.M. (CCH) 2230 (1995).

106. This assumes that the taxpayer can satisfy the regular criteria for capital gains (e.g., the one-year-holding-period requirement). Assuming satisfaction of such requirements, the taxpayer is incentivized to avoid the automatic ordinary tainting of contingent payments under § 1253.

107. *See* Treatment of Certain Transfers of Property to Foreign Corporations, 81 Fed. Reg. 91,012, 91,015 (Dec. 16, 2016) ("[The] allocation problem is acute . . . because goodwill and going concern value are particularly difficult to distinguish (perhaps are even indistinguishable) from . . . intangibles [like trademarks].").

Similar to the prior § 865 analysis, *International Multifoods* might dissuade such an attempt given the encapsulating franchise.[108] In this regard, the *Canterbury* decision referenced in *International Multifoods* involved § 1253.[109] Canterbury, however, recognized the ability to separate out some going concern value from the franchise.[110] As discussed previously, going concern value closely aligns with goodwill.[111] So even in a franchise case, some seller incentives remain to push value onto the closely aligned going concern value and perhaps even goodwill.[112]

Furthermore, not all businesses involve the goodwill-encapsulating franchise. Consider now the prior Bud's Bar & Grill example, again appropriately modified to expose the contingent payment issues.

b. *Example 2B: Sale of Bud's Bar & Grill*

In the original example, Bud Selig sold Bud's Bar & Grill to Buddy Buyer for $10,800,000 fixed consideration. As above, assume now instead the following mixture of consideration: $5,400,000 payable at closing plus a contingent 10% of revenue for the next five years.

Similar to Example 1B, the intangible asset allocation would not impact the buyer's taxes under § 197.[113] But such allocation would impact significantly the taxes of seller Bud given the lack of any goodwill-encompassing franchise. Similar to the earlier § 865 analysis, non-franchise cases place tremendous tax pressure on the intangible asset allocation.

Furthermore, as we saw previously, a taxpayer's opportunities increase as the listed intangibles decrease under the relevant tax provision. In this regard, § 1253 applies to just franchises, trademarks, and trade names. In comparison, § 865 includes also patents, copyrights, secret processes or formulas, trade brand, and a residual "other like

108. *See supra* section II.B.

109. Albeit, the case involved a now-outdated aspect of § 1253. This aspect concerned the buyer's treatment rather than the seller. Prior to its 1993 amendment in connection with the enactment of § 197, § 1253(d)(2)(A) permitted depreciation over no more than ten years for qualified payments made for a franchise or trademark. *Canterbury* involved the application of this (now-outdated) aspect of § 1253. Canterbury v. Comm'r, 99 T.C. 223, 245 (1992). For more on this former provision, see *infra* notes 165–69 and accompanying text.

110. In particular, the court separated out the "workforce in place" component of going concern value. *Canterbury*, 99 T.C. at 253. Interestingly, note how this workforce in place (denied depreciation under *Canterbury* due to its lack of a defined useful life) is somewhat reminiscent of the player contracts permitted depreciation over five years in the Bud Selig case (based on the average contract duration).

111. See earlier reference to this distinction *supra* note 103 and accompanying text.

112. As to possible remaining goodwill attempts even in the franchise context, see *supra* note 86.

113. As discussed *supra* note 38, the buyer depreciates contingent payments over the remaining life left on the original fifteen-year timeline.

property."[114] Thus, § 1253 expands the goodwill opportunities relative to § 865. Importantly, these other assets can be associated with goodwill, similar to trademarks.[115] So even if goodwill associated with the trademark remains subject to § 1253,[116] this portion of goodwill must be separated out from the goodwill associated with other intangibles like patents, trade secrets and copyrights.

2. Fixed-Consideration Incentives

This section highlights various provisions of the Code which preserve sellers' allocation issues even on fixed consideration. In addition to § 1253, the Code provides a mixture of (1) taxpayer-favored rules on the sale of self-created patents and (2) taxpayer-*dis*favored rules on the sale of self-created copyrights. The taxpayer-friendly § 1235 allows qualified patent creators to receive capital gains even if they otherwise would not qualify due to a professional-inventor status or failure to hold the patent for the requisite one year.[117] In the other direction,

114. And further recall how § 865 already presented a more narrow range than either § 197 or § 936. *See supra* note 97 and accompanying text.

115. *See, e.g.*, Oakley Inc. v. Sunglass Hut Int'l, 61 U.S.P.Q.2d (BNA) 1658, 1667–68 (C.D. Cal. 2001) ("If Defendants are permitted to continue to sell their [product] during the pendency of this lawsuit they will erode [plaintiff's] exclusivity and goodwill associated with these products. . . . Accordingly, the Court finds that if the Defendants are not enjoined, there is a likelihood of erosion to [plaintiff's] market presence and its *goodwill* associated with its patented [product]." (emphasis added)); *see also* MARTIN D. FERN, 7 WARREN'S FORMS OF AGREEMENTS § 8.6 (Matthew Bender ed. 2017) ("'Intangible Personal Property' shall mean all intangible properties owned by the Company . . . includ[ing] (i) the name . . . and all other registered and unregistered trademarks, service marks, trade names and slogans, all applications therefor, and all associated goodwill; (ii) all statutory, common law and registered copyrights, all applications therefor and all associated goodwill; (iii) all patents and patent applications, all associated technical information, shop rights, know-how, trade secrets, processes, operating, maintenance and other manuals, drawings and specifications, process flow diagrams and related data, and all associated goodwill . . . ."); *id.* § 63.2 ("Seller hereby irrevocably sells . . . to Buyer all of its . . . intellectual and industrial property rights associated with the Domain Name . . . , including but not limited to trademarks, service marks, trade names, trade dress, logos, designs, copyrights, patents, and trade secrets together with all goodwill associated with any of the foregoing (if any), and all other intellectual and industrial property rights related thereto, including all renewals and extensions thereof (collectively 'IP').").

116. In this regard, *International Multifoods* relied on the fact that § 865(d)(2) explicitly included goodwill in its coverage. *See supra* note 79. In contrast, § 1253 does not explicitly include goodwill in its coverage. On the other hand, *Canterbury* nonetheless included associated goodwill within the meaning of franchise for § 1253 purposes. *See supra* notes 109–10 and accompanying text. A similar approach would include goodwill associated with the trademark within the reach of § 1253.

117. Technically, the regular rules require a holding period of more than one year (i.e., a year and a day). I.R.C. §§ 1(h), 1222 (2012). Further note how a professional-inventor status also usually would negate capital gains under § 1221(a)(1). In

the taxpayer-unfriendly § 1221(a)(3) denies capital gains for self-created copyrights and similar property even if the taxpayer otherwise qualifies for capital gains.[118] And linking back to subsection III.C.1, fixed payments for trademarks can qualify for capital gains if they satisfy the regular capital gains rules *and* the special § 1253 trademark rules.[119]

These varying rules for different intellectual property raise allocation issues even for fixed-payment business sales. A goodwill allocation could benefit a seller who might otherwise fall prey to § 1221(a)(3). For instance, if Bud wrote the restaurant's recipe book himself, he could benefit from an allocation to goodwill and away from the copyright. In the other direction, professional sellers could benefit from allocations to patents and away from goodwill.[120] This would incentivize a government quest for goodwill reminiscent of the landscape prior to the 1993 enactment of § 197.

IV. RESPONSES TO GOODWILL HUNTING GONE BAD

Part III highlighted the ongoing goodwill problems despite the recent § 367 regulations. This Part therefore proposes legislative corrections to the remaining problematic areas.[121] Section IV.A first

addition, note how a patent transferor still needs to satisfy other criteria under § 1235 such as the transfer of all substantial rights, discussed in greater detail *infra* notes 175–76 and accompanying text. Finally, the benefits of § 1235 extend also to qualified financing individuals, who acquire the patent prior to actual reduction to practice. I.R.C. § 1235(b)(2) (2012). As discussed *infra* note 118, the recent tax bill extended § 1221(a)(3)(A) to include self-created patents and comparable property. As such, a patent creator must now satisfy § 1235 in order to obtain capital gains treatment.

118. Prior to the recent tax bill, § 1221(a)(3)(A) denied capital gains to "a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer whose personal efforts created such property." The Tax Cuts and Jobs Act, however, extended § 1221(a)(3)(A) to include patents and comparable property like inventions, models, and designs. The denial extends, in other limited circumstance, to taxpayers as well under § 1221(a)(3)(B), (C).

119. As discussed *supra* note 105 and accompanying text, the lack of substantial contingent payments is one such additional requirement. As discussed *infra* note 176, § 1253 has some additional requirements.

120. As noted above, § 1235 can overcome an otherwise denial of capital gains to professional sellers under §1221(a)(1).

121. In contrast to the recent § 367 *regulatory* response, this Article proposes legislative changes for a combination of reasons. First, § 367 presented a unique regulatory interpretative response due to its dual components (§ 367(a) and § 367(d)). The interpretative regulations avoided a statutory conflict via a limited partial response (mandating application of *either* § 367(a) or § 367(d)). The additional goodwill-hunting sections highlighted here lack such a comparable opportunity. For instance, § 865(d)(3) explicitly carves out goodwill, blocking a regulatory workaround. In addition, even § 367's partial regulatory response raises potential taxpayer challenges to the regulatory authority. And furthermore, the limited regulatory approach still leaves planning opportunities on the table. For a possi-

resolves the § 865(d) sourcing difficulties by replacing the current problematic goodwill exception. Foreign-source status should require instead the actual foreign taxation of the intangibles gain. Section IV.B then proposes a simple solution to the contingent payment problem: the removal of trademarks from the troublesome § 1253.[122] Section IV.C then rectifies the capital gains problem for fixed payments. Drawing upon § 197, the specialized §§ 1221(a)(3) and 1235 capital gain rules should apply only to separately sold patents and copyrights and not to those sold as part of a business.

A. Replace Goodwill-Sourcing Exception with Foreign Taxation

As developed below, goodwill now operates as a poor proxy under § 865(d)(3) for the real legislative goal. Congress wanted to link the usage of foreign tax credits to actual foreign taxation of any intangibles gain.[123] But goodwill cannot achieve this mission, especially given the inability to separate goodwill value from other associated intangibles. This section therefore proposes the substitution instead of a more direct link to the underlying goal. As shown below, special treaty sourcing rules provide a clear roadmap for the feasibility today of such a direct connection.

1. Underlying Goals of § 865(d)(2) and (d)(3)

The § 865(d) legislative history evidences a Congressional desire to link the desired foreign sourcing of gains to the actual foreign taxation of such gains. As developed below through an illustrative example, such linkage prevents manipulations around the foreign-tax-credit limitation. The following excerpt from the 1986 legislative history evidences these points:

> Congress believed that source rules for sales of personal property should generally reflect the location of the economic activity generating the income, taking into account the jurisdiction in which those activities are performed. . . . [W]ith substantial reduction of U.S. tax rates provided in the Act, more U.S. taxpayers would have excess foreign tax credits and that,

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ble limited regulatory response to the § 1253 issue, see Izzo, *supra* note 102. But as noted therein, the suggested regulatory response fails to address the primary § 1253 culprit: the automatic tainting of the contingent payments regardless of their amount. And given such a statutory provision, an appropriate change requires legislative action.

122. As noted above, § 1253 includes both trademarks and trade names in its coverage (in addition to franchises). For ease of exposition, this section again will use "trademarks" to reference both trademarks and trade names.

123. At first blush, it might seem like the taxpayer could benefit from a foreign tax credit (FTC) on such income only where the taxpayer actually paid tax on such income. Foreign sourcing of the income could provide additional FTC benefits even without any such foreign tax, however, if the taxpayer has excess foreign taxes (above the existing credit limits) on other foreign income.

> therefore, *there would be more incentive after tax reform to generate low-taxed foreign source income to absorb the excess foreign tax credits*. Congress noted that the foreign tax credit mechanism was originally established to eliminate double taxation of the same income by the United States and foreign countries. *Congress did not believe that the potential for double taxation existed where income had little likelihood of attracting foreign tax*. With the above in mind, Congress modified prior law[ ] . . . [to] treat as foreign source income only that income which is generated within a foreign country and *which is likely to be subject to foreign tax*. . . .
>
> . . . .
>
> . . . Congress realized that in cases where manipulation of [the former "place of sale" rule] occurs, there is little likelihood that foreign countries tax this income. Congress believed in these circumstances that the residence of the seller should govern the source of the income since countries rarely tax personal property gains on a source basis.[124]

The following example illustrates the Congressional concern over foreign-tax-credit manipulation. Assume a corporate taxpayer reported $2,000,000 of net income and paid $510,000 foreign income tax. Assume initially that the corporation appropriately reports an equal split of U.S.- and foreign-source income ($1,000,000 for each category). Before the foreign tax credit, the corporation's U.S. tax liability equals $680,000 (determined at the 34% general corporate rate).[125] The corporation can offset only half of such amount ($340,000) with the foreign taxes paid under § 904,[126] leaving $340,000 payable to the U.S. government.[127]

Assume now that the taxpayer reports an additional $500,000 of foreign-source income without any change to the foreign taxes paid.[128] If so, the usable tax credit increases to the full $510,000 foreign tax,[129] reducing the payable U.S. tax to just $170,000.[130] This tax-planning opportunity stems from the general aggregate approach of the foreign tax credit.[131] As demonstrated above, such aggregate approach allows low (or no) tax foreign-source income to liberate excess foreign tax paid on some other foreign income.[132]

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124. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 917–18 (Comm. Print 1987) (emphasis added).
125. *See* I.R.C. § 11 (2012).
126. The initial $680,000 tax bill times the 1/2 ratio of foreign-source income to all income ($1,000,000/$2,000,000). *See supra* note 67. Note how this equals the 34% U.S rate times the $1,000,000 of foreign source income.
127. This would equal $680,000 initial tax less the $340,000 credit.
128. Similar to *International Multifoods*, *supra* note 78 and accompanying text, the taxpayer might attempt this through an aggressive goodwill allocation.
129. The initial $680,000 tax bill times the ¾ ratio of foreign source income to all income ($1,500,000/$2,000,000). Note how this equals the 34% U.S rate times the $1,500,000 of foreign source income.
130. $680,000 initial tax less the $510,000 credit.
131. As to be discussed *infra* notes 139–42 and accompanying text, the foreign tax credit operates on a more specific income basis in certain cases.
132. "Excess foreign tax" means tax imposed at a rate above the U.S. rate. For instance, in the above example, the corporation paid $510,000 foreign tax on only

2. Goodwill as a Poor Proxy for Real Goal

As evidenced by the legislative history above, Congress desired linkage of foreign sourcing to the foreign taxation of such income. Congress provided the goodwill exception to the general U.S. sourcing of intangibles gain as a proxy to accomplish such goal. But as demonstrated throughout Part III, goodwill cannot be readily separated from other overlapping intangible assets.[133] Goodwill thus fails its mission as desirable proxies should be readily determinable.[134] In addition to such practical shortcoming, there is no clear linkage of the proxy to the underlying goal even in theory. For instance, the legislative history fails to support the *International Multifoods* dividing line between goodwill associated with the listed intangibles and unassociated goodwill.[135] In addition, *International Multifoods* also

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$1,000,000 of legitimate foreign income. This suggests a foreign tax rate of 51% on such income, higher than the U.S. 34% rate.

133. Recall again the lessons from § 367 provided in the preamble to the § 367 regulations. *See supra* note 28 and accompanying text.

134. For recognition that proxies should be readily determinable, see, for example, RICHARD POSNER, ECONOMIC ANALYSIS OF LAW (2014) ("The use of a single, readily determinable characteristic such as age as the basis for an employment decision economizes on the cost of information."); Stephen Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 596 n.235 (2003) ("Firms can readily determine their respective equity and debt costs of capital, which seems a reasonable proxy for measuring the value of (and thus the contribution of) financial inputs."); Nina Kohn, *Rethinking the Constitutionality of Age Discrimination: A Challenge to a Decades-Old Consensus*, 44 U.C. DAVIS L. REV. 213, 279 (2010) ("For example, chronological age may be considered a valid proxy for individual characteristics such as maturity, frailty, vulnerability, or worthiness. This perception, combined with the administrative appeal of chronological age as a proxy (chronological age criteria are easy to implement because chronological age can be readily determined without the need for discretion), encourages over-reliance on such criteria."); Jody Kraus, *Decoupling Sales Law from the Acceptance-Rejection Fulcrum*, 104 YALE L.J. 129, 144 (1974) ("There is no need to use the acceptance-rejection fulcrum as a proxy for possession when possession can be even more easily and accurately determined than rejection and acceptance.").

135. As discussed above, *International Multifoods* distinguished associated and unassociated goodwill, with only the later qualifying for foreign sourcing. *See* Int'l Multifoods Corp. v. Commissioner, 108 T.C. 25 (1997); *supra* section II.B. For this distinction to achieve the desired goal even in theory, foreign jurisdictions would have to tax only the latter unassociated goodwill. There is no support in the legislative history for this proposition. More generally, the legislative history lacks a clear explanation of the goodwill link to actual foreign taxation. Perhaps this correlates to the notion in the § 367 legislative history that foreign goodwill generally lacks abuse potential. For an example of the recent reference to such legislative history in the preamble to the § 367 regulations, see Treatment of Certain Transfers of Property to Foreign Corporations, 81 Fed. Reg. 91,012, 91,014–15 (Dec. 16, 2016). As such, Congress might have believed that foreign jurisdictions more likely would tax foreign-generated goodwill. But again, the recent § 367 regulations counter this non-abusive notion of goodwill, and *International Multifoods* highlights the theoretical difficulties in utilizing (undefined)

highlights how some of the other listed intangibles, such as trademarks, might face meaningful foreign tax.[136]

3. Substitute Actual Taxation and Link to Treaty Rules

Mindful today of all the difficulties separating out goodwill,[137] why not link foreign-source status directly to the actual foreign taxation of intangibles gain? The legislative history and the example above might suggest initial concern over foreign-tax-credit manipulations where the gain faces only a low foreign tax rate.[138] Special treaty-based sourcing rules developed over time, however, show a clear pathway to reform. Section 865(h) provides a taxpayer election to report intangibles gain as foreign source if a treaty sources the gain to a foreign country *and* the taxpayer agrees to calculate the credit limit separately for such gain.[139] This latter "separate basket" requirement is the key, as demonstrated by adjustments to the earlier example.

In the above example, an extra $500,000 of reported foreign-source income liberated $170,000 foreign tax credits independent of any foreign tax payments. To engage the separate basket aspect, further assume now that the taxpayer actually paid $50,000 foreign tax on this extra $500,000 of foreign-source income. This would not change the above result of $170,000 credit liberation under § 904's regular aggregate approach.[140] The separate basket approach, however, neatly limits the additional credit allowance to just the $50,000 foreign tax paid on the foreign-source income in question. The separate basket ap-

goodwill as an appropriate standard. In addition, *International Multifoods* also highlights how some of the other listed intangibles, such as trademarks, might face meaningful foreign tax.

136. Consider the following quote from one of the taxpayer's employees:

> My main concern, though, is with uncertain tax consequences surrounding the transfer of trademarks in the Peoples Republic of China, Taiwan, Indonesia, Malaysia, Singapore, and Hong Kong. It is possible that the trademark transfers could generate a tax in these countries. Therefore, if amounts are to be allocated to the trademarks associated with these countries, the purchase price allocated to them should be as little as possible.

Int'l Multifoods, 108 T.C. at 34.

137. Recall again the lessons from § 367 provided in the preamble to the § 367 regulations. *See supra* note 28 and accompanying text.

138. Recall the legislative history quote to that effect. *See supra* note 124. For an example of this concern where the taxpayer pays some foreign tax but at a rate below the U.S. rate, see the modified example *infra* notes 141–42 and accompanying text.

139. Subsections 904(d)(6) and (h)(10) provide comparable rules. As discussed *supra* note 67, the § 904 credit also applies separately to passive income. I.R.C. § 904(d)(6), (h)(10) (2012); *see also* I.R.C. § 904(d)(1)(A) (2012) ("The provisions of subsections (a), (b), and (c) and sections 902, 907, 960 shall be applied separately with respect to . . . passive category income . . . .").

140. See *supra* note 67 and accompanying text for the general credit approach of § 904(a).

proach essentially limits the increased credit to the lesser of (1) the actual foreign tax paid on the separate basket income ($50,000 here)[141] or (2) the product of the income times the U.S. 34% rate ($170,000 here).[142]

As background, § 865(h) adopted the separate basket election as a response to the "later in time" treaty issue.[143] In addition, the appeal of double taxation relief accelerates in the treaty context given the negotiated reciprocity with another jurisdiction.[144] The current goodwill exception, however, evidences a similar Congressional desire to provide appropriate relief from the potentially onerous intangibles-sourcing rule. In particular, the regular intangibles rule imposes the negative U.S. sourcing even upon gain subject to significant foreign tax.[145] And so expansion of the tried-and-tested treaty rules appeals as the best way to heed both the Congressional desire for an intangibles escape hatch and the status quo bias against untested reforms.[146]

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141. Like the regular aggregate rules under § 904, the credit can never exceed the actual foreign taxes paid. The separate basket approach addresses the liberation concern by forcing the taxpayer to calculate that limit separately on a smaller component of overall income.

142. This amount would be 34% times only the $500,000 of separate basket intangible gain.

143. Under the "later in time" rule, legislation generally overrides conflicting treaty provisions already in place. For a discussion of this concept and the relationship to § 865(h), see ELIZABETH KESSENIDES, N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON TREATY RE-SOURCING RULES 11 (2014), https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1313.html.

144. *See* Walter Hellerstein, Georg Kofler & Ruth Mason, *Constitutional Restraints on Corporate Tax Integration,* 62 TAX L. REV. 1, 9–10 (2008) ("[B]y refusing to extend benefits unilaterally [in a different context], states may hope to negotiate for reciprocal economic double tax relief obligations in tax treaties.").

145. In an interesting link to § 367, Congress granted foreign sourcing on § 367(d)'s imputed supper royalty. I.R.C. § 367(d)(2)(C) (2012). As a possible tradeoff, Congress also provided that the income would be ordinary. This tradeoff loses its bite in the parent–subsidiary context since corporations do not receive a lower capital gains rate (although it could impact their ability to use capital losses against the income). I.R.C. § 1211(a) (2012) (allowing capital losses only to the extent of capital gains).

146. For examples of the tried-and-tested-benefit, see Alschner, *supra* note 16, at 51 ("[I]nvestment law suffers from status quo bias: path dependency dominates over prolific innovation. Treaty design evolution, where it takes place, consists of states opting into and refining tried and tested language rather than trying out something new. This path dependency prevents more radical change, even where this change may be on balance beneficial."); Nicholas H.D. Foster, *Company Law Theory in Comparative Perspective: England and France*, 48 AM. J. COMP. L. 573, 613 (2000) ("[T]he [Steering] Group writes that: many of the more radical reforms have been tried and tested for some years in advanced economies with common law traditions like our own and their success there has given us confidence in them." (citations omitted)); Richard H. Walker, *Evaluating the Preemption Evidence: Have the Proponents Met Their Burden*, 60 LAW & CONTEMP. PROBS. 237 (1997) ("Throughout the preemption debate, the Commission has preached an im-

In sum, Congress should extend the § 865(h) election to all "intangibles" gain, irrespective of any treaty interplay. As a corollary change, Congress should delete the ineffective, and confusing, § 865(d)(3) goodwill exception.[147]

B. Franchise Attack Gone Bad: Drop Trademarks from § 1253

As developed below, § 1253 should be amended to drop trademarks from its coverage for a combination of reasons. First, as evidenced by the legislative history, tax-avoidance concerns over split-interest franchises motivated the enactment of § 1253. Second, § 1253's ordinary income tainting of contingent payments for trademarks contradicts other tax rules which sanction capital gains for other intellectual property. Such ordinary income tainting not only presents an unduly harsh outcome for trademarks but also presents significant allocative difficulties for business sales. In addition, while § 1253 originally provided beneficial buyer consequences, subsequent changes have essentially negated this balanced offset to buyers.[148] Finally, the elimination of trademarks from § 1253 would address needless discontinuities and interpretative issues, especially regarding trademark litigation receipts.[149]

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portant message: The short time since passage of the Act has not allowed for sufficient practical experience with its key provisions or for many court decisions interpreting those provisions. . . . This alone mandates a cautious approach toward making federal securities law the exclusive law of the land.").

147. In addition to its questionable theoretic and practical support, § 865(d)(2) and (d)(3) together present a confusing statutory scheme as both reference goodwill. Subsection 865(d)(2) references it under its U.S.-sourcing rule while § 865(d)(3) singles it out under its foreign-sourcing rule. As discussed at note 79, *International Multifoods* tried to reconcile the confusing statute. But for all the above reasons, the statute would benefit from a necessary change.

148. In addition to increasing the seemingly unjustified harshness of the rules, it also increases the incentives to structure around. *See infra* note 169 and accompanying text.

149. For a prior commentary also challenging § 1253's application to contingent payments for trademarks, see Izzo, *supra* note 102. Such prior commentary significantly differs from my approach both in its mode of analysis and its scope of reform. As to the analysis, the prior article did not focus on the broader goodwill-hunting aspect, the central theme of this Article. Somewhat accordingly, it proposes a much narrower reform, limited to the substantiality trigger for the tainting of fixed payments. As discussed *supra* note 105 and accompanying text, even fixed payments become tainted when the contingent payments constitute a substantial component of the overall consideration. The prior article proposes a more lenient approach to the substantiality tainting of fixed payments. Izzo, *supra* note 102, at 277–78 (proposing a safe harbor exemption for contingent payments which expire within ten years). This proposal is much narrower than my approach in that it does not address the automatic tainting of the contingent payments themselves under § 1253(c). In addition, given the lack of focus on the

1. Congressional Motivation: Split-Interest Franchises

As explained by the *Syncsort* court, "Section 1253 . . . was enacted in response to a series of conflicting court decisions dealing with the extent to which *franchisees'* payments to *franchisors* qualify for capital gains treatment."[150] Furthermore, "[a] franchise is a business. Congress enacted Section 1253 in response to a franchise boom in which franchisors licensed various assets to franchisees and thereby helped establish the franchisees in the business of distributing, selling, or providing the goods, services, or facilities within specified areas."[151] In particular, various taxpayers claimed capital gains on their transfers of Dairy Queen franchise rights despite their retention of various control rights and the significant separation of the ownership rights among many recipients. The circuit courts' differing results in these franchise cases furthered the need for a Congressional response.[152] Thus, Congressional concern over the proper treatment of split-interest franchising provided the motivation for § 1253.[153]

The fact that the original House bill did not even apply to trademarks further supports *Syncsort*'s franchise-motivation conclusion. And while the Senate marked up the House bill to include trademarks, a close reading of the Senate Report likewise supports *Syncsort*'s franchise-motivation take.[154] First, the Senate Report discussion very closely tracks the House's franchise-based discussion. Without any deeper explanation, the Senate Report simply states that "a similar situation [to franchises] exists in the case of transfers of

goodwill hunting aspect, the article does not address the other reform areas covered in this Article.

150. Syncsort Inc. v. United States, 31 Fed. Cl. 545, 548 (1994) (emphasis added) (citations omitted).

151. *Id.* at 548–53 (emphasis added). This case held that amounts received on multiple franchise transfers were ordinary income since the taxpayer retained significant rights (including substantial contingent payments). As part of its analysis, the court rejected the taxpayer's argument that the portion of the payments attributable to trade secrets of the franchise fell outside § 1253.

152. *Id.* at 548 (citing Dairy Queen of Oklahoma, Inc. v. Commissioner, 250 F.2d 503 (10th Cir. 1957)).

153. The very distinctive legislative histories behind §§ 865 and 1253 explain my different solutions for each area. The § 865 legislative history highlights the inappropriateness of my § 1253 solution for the income sourcing difficulties. Scaling back § 865(d)(2)'s U.S.-sourcing rule to just franchises would frustrate, rather than further, the congressional goals. In contrast to § 1253's legislative history, § 865(d)(2)'s legislative history evidences no specific focus on franchises. In fact, as originally enacted, § 865(d)(2) did not even include franchises, an apparent oversight which was corrected by the 1988 Act. *See supra* note 87.

154. *See* S. Rep. No. 91-552, at 210 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 2027, 2245.

trademarks."[155] And the Senate Report cites just a Dairy Queen franchise case as support for the legislative change.[156]

2. Inconsistency and Practical Allocation Issues

Consider now the stated reason behind § 1253's adverse treatment of contingent payments. Returning to the legislative history, Congress explained that annual contingent payments seem more akin to license royalties than proceeds from the sale of property.[157] Despite some initial appeal, § 1253's negative treatment of contingent payments contradicts the law for other property. For instance, the general installment sale rules specify how to report (capital) gain from contingent sales payments over time.[158] More specifically, the tax law explicitly permits capital gains on earn outs for other intellectual property like patents and copyrights.[159] Deeper analysis thus uncovers the inconsistency of § 1253's automatic denial of capital gains for contingent trademark payments. And linking back to the legislative history analysis above,[160] § 1253 targets trademark earn outs without any explanation for this unequal harshness compared to copyrights and patents.[161]

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155. *Id.* at 207, *as reprinted in* 1969 U.S.C.C.A.N. at 2241.
156. *Id.* at 208 n.1, *as reprinted in* 1969 U.S.C.C.A.N. at 2242 n.62.
157. *Id.* at 208–09, *as reprinted in* 1969 U.S.C.C.A.N. at 2243 ("It also would appear that the receipt of contingent payments could be viewed as constituting a continuing economic interest in the subject matter as well as being analogous to the receipt of royalty or rental income."). Note that royalties are taxed as ordinary income as they lack the requisite sale or exchange for capital gain treatment. *See* I.R.C. §§ 1(h), 1222 (2012).
158. An installment sale involves at least one deferred payment after the year of sale. I.R.C. § 453(b)(1) (2012). Under a qualified installment sale, taxpayers generally report a fixed proportion of each payment as gain based on a ratio of the total gain to the total payments. § 453(c). This calculation is relatively straightforward where the total payments are fixed. Special difficulties arise, however, where some or all of the payments are contingent (as neither total gain nor total payments are determinable at the outset). Treas. Reg. § 15a.453–1(c) (1969) provides a series of rules for contingent payments. The details of such rules are beyond the scope of this paper as the mere presence of such rules suffices for our purpose. In particular, the presence of § 15a.453–1(c) demonstrates how contingent payments generally do not negate a transaction which otherwise qualifies as a sale for tax purposes.
159. *See supra* note 104. One might note that § 1235 is designed to encourage innovation by providing taxpayer-friendly rules to patent inventors. See *infra* note 178. But that cannot explain the adverse treatment of trademarks compared to copyrights (on contingent payments) as self-created copyrights receive tax-disfavored treatment under § 1221(a)(3). See the discussion of § 1221(a)(3) (2012) *supra* note 118. For a prior commentary making a similar point, but only as to patents (which arguably can be distinguished as noted right above), see Izzo, *supra* note 102, at 273.
160. *See* subsection III.B.1.
161. This taxpayer-adverse rule on contingent payments thus might be explained more readily in the franchise context. By definition in the franchise context,

This disparate treatment also raises serious practical issues on a business sale. As developed previously, differential tax provisions which require separate allocations between closely associated intangibles are ripe with mischief. While not completely immune, § 1253's application to "franchises" at least minimizes these concerns due to the encapsulating nature of the franchise.[162] But § 1253's application to non-franchise trademarks lacks any such saving grace,[163] presenting the problematic scenario rejected by the recent § 367(d) regulations.[164]

3. *Subsequent Changes Leave One-Sided Punitive Regime*

Section 1253 originally provided a balanced approach. As an offset to the recipient's ordinary income, the payer could deduct each year's contingent payment.[165] But § 1253 now denies such deduction unless

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transferors are splitting up their ownership interests. And this slicing up of ownership interests is another indicator of an ordinary income license rather than a sale. *Compare* I.R.C. § 1253(b)(1) (2012) ("The term 'franchise' includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, *within a specified area*."), *with* Treas. Reg. § 1.1235-2(b)(1)(i) (as amended in 1980) (providing that a transfer of patent rights "which is limited geographically within the country of issuance" fails the § 1235 "all substantial rights" requirement).

162. *See supra* notes 108–09 and accompanying text.

163. *See supra* notes 114–16 and accompanying text. As noted previously, BJ's restaurant provides a good example of restaurant trademarks. *See supra* note 42. For their disclaimer highlighting valuation difficulties on such trademarks, see BJ's RESTAURANTS, INC., FORM 10-K (2013), https://www.sec.gov/Archives/edgar/data/1013488/000119312513074282/d447638d10k.htm#toc447638_24 [https://perma.unl.edu/G8TS-C5SL] ("We believe that the trademarks, service marks and other proprietary rights have significant value and are important to our brand-building effort and the marketing of our restaurant concepts. However, there are other restaurants and retailers that use the name 'BJ's' in some form or fashion throughout the United States. We have in the past protected, and expect and intend to continue to vigorously protect, our proprietary rights. We cannot predict whether steps taken by us to protect our proprietary rights will be adequate to prevent misappropriation of these rights or the use by others of restaurant features based upon, or otherwise similar to, our concept. It may be difficult for us to prevent others from copying elements of our concept and any litigation to enforce our rights will likely be costly."). Note that BJ's does not operate franchises as all restaurants are company owned. *See id.*

164. As discussed throughout this section, I recommend deletion of trademarks from § 1253 for several reasons. With a focus on just this even-handed treatment point, Congress alternatively could extend the ordinary income treatment for contingent payments to all other intangibles. A broader perspective, though, counsels in favor of curtailing, rather than extending, the adverse treatment of contingent payments.

165. Thus, both sides were treated like a royalty license. The Senate Report nicely provides the balanced approach. S. REP. NO. 91-552, at 210 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 2027, 2244 ("[T]he committee amendments . . . provide that all amounts received or accrued by the transferor on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name, which are contingent

the contingent payments continue for the full transfer term.[166] Given the unlimited duration of trademark legal rights, this often negates such deduction (other than for limited-term licenses).[167] Section 1253 thus now provides just a one-sided negative result to the seller on transfers which otherwise qualify as a sale.[168] Such inconsistency

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on the productivity, use, or disposition of the franchise, trademark, or trade name transferred are to be treated as ordinary income. Contingent payments would include continuing payments . . . measured by a percentage of the selling price of products marketed or based on the units manufactured or sold, or any other similar method based upon production, sale or use, or disposition of the franchise, trademark, or trade name transferred. The committee amendments also provide that amounts paid or incurred during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred, are to be deductible by the transferee as trade or business expenses.").

166. *See* I.R.C. § 1253(d)(1)(B)(ii)(I) (2012). This includes any renewals. *See* § 1253(d)(3). The amendment was made in connection with the enactment of § 197. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261(c), 107 Stat. 312, 532–40.

167. *See* JEFFREY MAINE & XUAN-THAO NGUYEN, INTELLECTUAL PROPERTY TAXATION: PROBLEMS AND MATERIALS 147 (2d ed. 2015) ("[S]ection 1253(d)(1) applies mainly to payments pursuant to licenses (and not sales) . . . .") Since trademarks can extend indefinitely, qualification would seem to require an agreement to pay the contingent amounts in perpetuity. This would be contrary to the typical business deal. *See* Cecila Jeong & Charmin Shiely, *Getting the Purchase Price Right: Earn-outs, Escrows, and Post-Closing Adjustments in M&A Transactions*, SCHWABE, WILLIAMSON & WYATT (Nov. 22, 2016), http://www.schwabe.com/newsroom-publications-14655 [http://perma.unl.edu/K7FP-NBSF] ("Most earn-out periods conclude after the expiration of a specified length of time—generally between two and five years after the closing."). But some deals are structured with royalties in perpetuity, such as the classic sale by the owners of the Spirits of St. Louis, a former American Basketball Association franchise. *See* Monte Burke, *The NBA Finally Puts an End to the Greatest Sports Deal of All Time*, FORBES (Jan. 7, 2014), https://www.forbes.com/sites/monteburke/2014/01/07/the-nba-finally-puts-an-end-to-the-greatest-sports-deal-of-all-time/#6ee551254f0b [http://perma.unl.edu/5SAN-EAPU].

168. Especially since substantial contingent payments can also taint fixed consideration as ordinary, note how the original § 1253 also provided a payer benefit on the fixed payments. At the time of the enactment of § 1253, § 197 was not on the books yet, and so trademark payments generally were not depreciable due to their lack of a useful life. Original § 1253(d)(2), though, provided some balance as it allowed the payer to depreciate fixed payments over ten years. Once again, the Senate Report nicely illustrates the balanced approach. S. REP. NO. 91-552, at 210 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 2027, 2245 ("Where, however, the agreement is not a sale under the committee amendments, then it is provided that the transferee may deduct the initial payments over the period of the agreement to which they are attributable but, in no event, over more than 10 taxable years. This treatment is to apply in these cases to any payment, other than a contingent payment, in discharge of a principal sum agreed upon in the transfer agreement. Thus, in the case of a single payment, the transferee is to be allowed to deduct the payment ratably over 10 years if the transfer agreement is for a period of more than 10 years, or ratably over the period of agreement, if not more

provides a net adverse impact on the collective parties to the transaction, reinforcing the incentives to allocate away from the trademark.[169]

4. Discontinuities in Trademark Litigation

Finally, an intriguing litigation case highlights additional difficulties with the inclusion of trademarks under § 1253. In *Inco Electroenergy v. Commissioner*,[170] the taxpayer owned the trademark EXIDE for use in its battery business and challenged Standard Oil's use of EXXON in any battery-related business. The parties ultimately settled, with taxpayer receiving a $5,000,000 payment for dropping its opposition to the EXXON use. The IRS challenged the taxpayer's reporting of the settlement as capital gains. The court found in favor of capital gains since the settlement was for damage to the "trademarks and associated goodwill." Interestingly, the court did not even mention § 1253; rather, it applied general tax principles for sales versus licenses.[171]

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than 10 years."). But this beneficial aspect of § 1253 was eliminated with the enactment of § 197, which allowed fifteen-year recovery to trademark payments without regard to the recipient's consequences.

169. This links back to subsection III.B.2, which discussed allocating towards assets other than the trademark. Separately, an even-handed approach has several potential benefits. For instance, adverse interests between the parties can help to police the area as one side has an incentive to resist the other side's tax-motivated allocation. Also, perhaps somewhat related, favorable treatment on one side can ameliorate harsh treatment on the other side as the parties can adjust the purchase price for the tax benefits and detriments. In contrast, application of the rules in the franchising context are more likely to provide balance given an increased likelihood of ongoing payments for the full duration of the franchise. *See, e.g*., Gowdey's Estate v. Comm'r, 307 F.2d 816, 818 (4th Cir. 1962) ("Each [transferee] paid Gowdey an immediate sum upon the execution of the agreement and thereafter 35 cents per gallon on all mix used or sold within his territory.").

170. 54 T.C.M. 359 (1987).

171. While the initial dispute started before the § 1253 enactment in 1969, the payment was not made until 1973. For one commentator's linkage of the case to § 1253 (without further developing the § 1253 omission), see Ronald H. Jensen, *Can You Have Your Cake and Eat It Too?: Achieving Capital Gain Treatment While Keeping the Property*, 5 PITT. TAX REV. 75, 116–17 (2008) ("The $5,000,000 . . . may therefore be viewed as consideration for a transfer of an interest in the Exide trademark to Standard Oil in which case it would qualify as long-term capital gain. Standard Oil must have found substantial merit in taxpayer's claim that its Exide trademark included the right to use of the word 'Exxon.' Otherwise, it would not have paid the taxpayer $5,000,000. Under the law then and now, a transfer of an interest in a trademark will generally qualify for capital gain treatment unless the transferor retains significant powers over the transferred interest [under § 1253]. In the latter case, the transfer will be deemed a license and payments received under it will be taxed as ordinary income. Although the court did not pass on whether taxpayer had transferred an interest in its Exide trademark to Standard Oil, it rejected the IRS's contention that the settlement agreement was a mere license." (citations omitted)).

This omission raises open interpretative issues. For instance, would the court have reached the same result even after explicit consideration of § 1253?[172] Perhaps, as the fixed amount did not violate the contingent payment aspects discussed above. But § 1253(a) also provides for ordinary income treatment "if the transferor retains any significant power, right, or continuing interest."[173] And the case involved a transfer of much less than the owner's full interest as the owner retained its EXIDE trademark for its own use going forward. A § 1253 analysis plausibly could have gone either way. As evidenced by the franchise definition, § 1253 contemplates the possibility of split-interest transfers qualifying for capital gains so long as all other criteria are satisfied.[174] On the other hand, § 1253's legislative history linked trademarks to the § 1235 patent standard requiring a "transfer of all substantial rights."[175] And the § 1235 regulations now prohibit retentions for patents of the sort seen in the Inco case.[176]

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172. In addition, query whether § 1253 applies to just the separately determinable trademark value or include the entire settlement amount (including the associated goodwill). The *Syncsort* decision would suggest the latter. *See* Syncsort Inc. v. United States, 31 Fed. Cl. 545 (1994); *supra* note 151.

173. I.R.C. § 1253(a) (2012).

174. *See* § 1253(b)(1) ("The term 'franchise' includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, *within a specified area*." (emphasis added)).

175. H.R. REP. NO. 99-782, at 394 (1969) (Conf. Rep.) ("Your committee's bill provides an exception to the general rule. Under this exception, the general rule is not to apply with respect to amounts received or accrued, in connection with a transfer of a franchise, which are attributable to the transfer of all substantial rights to a patent, trademark, or trade name (or the transfer of an undivided interest therein which includes part of all such rights), to the extent the amounts are separately identified and are reasonable in amount. These amounts, as is the case with the transfer of a patent under section 1235, would be entitled to capital gains treatment.").

176. Transfers fail § 1235's "all substantial rights" requirement if they grant rights "limited geographically within the country of issuance" or "in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant"; or "less than all the claims or inventions covered by the patent which exist and have value at the time of the grant." Treas. Reg. § 1.1235–2(b)(1)(i), (iii)–(iv) (as amended in 1980). Further note how § 1253 does provide additional hurdles for capital gains above and beyond the general tax principles used by the *Inco Electroenergy* court. Note that § 1253(a) has open-ended possibilities apart from the enumerated list in § 1253(b). For one commentator's take that geographic divisions are problematic under the more stringent § 1253 standards, see Izzo *supra* note 102, at 269–70 ("Transfers that are limited as to geographic scope . . . are considered licenses, not sales. . . . In a geographically limited transfer, the seller takes his interest and splits it into two parts, retaining one part for himself, and transferring the other part to the buyer. For example, the seller could transfer to the buyer the exclusive right to use the trademark east of the Mississippi River. He thus would be reserving rights in the western half of the country to himself. This would clearly be divisive. . . . A division necessarily implies a retention of a significant right [within the meaning of § 1253] on the part of the seller.").

In any event, the lingering uncertainty about these questions lends further support to excising trademarks from the § 1253 franchise-designed rules. In this regard, the *Inco Electroenergy* court capably resolved the capital gains issue under general tax principles without the need for additional § 1253 principles.[177]

5. *Summary*

For all the foregoing reasons, Congress should remove trademarks from § 1253. Congressional concern over split-interest franchises justified the anti-capital gains approach of § 1253. Despite significant retentions, some courts validated the questionable capital gains claims of franchisors. This reasoning does not extend to business transfers involving trademarks outside the franchise context. In addition, developments over time have shown the practical difficulties for these non-franchise transfers. As such, the current inclusion of all trademarks in § 1253 fails on both theoretic and practical grounds.

C. Business Sale Override of §§ 1221(a)(3) and 1235

As noted above in subsection III.C.2, §§ 1221(a)(3) and 1235 provide varying capital gain rules for the sale of copyrights and patents. While a specific Congressional policy goal supports these disparate rules,[178] their joint operation on a business sale creates difficult allocation issues.[179] Fortunately, an existing statutory provision again provides the tried and tested pathway to reform. As discussed above, the buyer depreciates intangibles over a uniform fifteen-year period on a business acquisition. In essence, § 197 sets aside the specialized depreciations rules for patents and copyrights on business acquisitions. But the specialized depreciations rules remain intact for separately acquired patents or copyrights.[180] As discussed above, the desire to avoid messy allocation issues motivated this dual approach, distinguishing business and separate acquisitions.

In similar fashion, the specialized §§ 1221(a)(3) and 1235 rules can remain intact for separately sold copyrights and patents. But Congress should implement a newly crafted exception from those sections

177. This neatly takes us back to the start of this section regarding the legislative history. Section 1253 was enacted in response to the courts' inability to satisfactorily resolve capital gain issues in the franchise context. As discussed *supra* notes 155–56 and accompanying text, the legislative history is noticeably devoid of any troubling trademark cases outside the franchise context.

178. For instance, § 1235 was enacted to encourage innovative patent developments. S. REP. NO. 83-1622, at 439 (1969), *as reprinted in* 1954 U.S.C.C.A.N. 4621, 5082–83. This rationale was not extended to copyright development.

179. *See supra* note 120 and accompanying text.

180. As discussed *supra* note 30 and accompanying text, § 197(e)(4)(C) provides that patents and copyrights are subject to § 197 only if acquired as part of a trade or business.

for copyrights and patents sold as part of a business. The regular capital gains rules would then apply uniformly to intellectual property sold as part of a business.[181]

V. CONCLUSION

The recent tax bill counteracted taxpayer goodwill hunting on foreign-subsidiary transfers through a simple change to a Tax Code definition.[182] In the same spirit, another easy definitional fix would just remove trademarks from § 1253. The section's harsh contingent-payment rules then would apply to just the real Congressional target: split-interest franchises. In this regard, the limited nature of a franchise transfer helps to justify § 1253's capital gains override. In addition, franchises tend to subsume all business goodwill, thereby avoiding the troublesome allocation issues imbedded in non-franchise trademark transfers. Such trademark deletion also would address unnecessary discontinuities and interpretative issues, especially regarding trademark-litigation proceeds.

The remaining two solutions then favorably draw upon other existing provisions. While the § 1253 change above would address trademark-allocation disputes, similar issues plague copyrights and patents given §§ 1221(a)(3)'s and 1235's specialized capital gains rules. These seller's-side allocation issues invoke the pre-1993 law for buyers. This inverse recognition then uncovers the straightforward correction. Similar to § 197, the seller-side rules should apply uniformly to all intangibles on a business sale. Congress could just provide a new exception from §§ 1221(a)(3) and 1235 for copyrights and patents sold as part of a business, leaving those provisions in place for separately sold copyrights and patents.[183]

Finally, the desirable § 865 reform likewise utilizes existing law.[184] Goodwill currently serves as a proxy for the foreign taxation of intangibles gain.[185] However, time has shown the problems with this

181. This assumes that Congress also would excise trademarks from § 1253, as proposed above. Note that the *separately acquired* distinction would not make sense for trademarks since trademarks typically implicate the sale of a business. Treas. Reg. §1.197–2(e)(2)(i) (as amended in 2017).

182. *See supra* section III.A.

183. As discussed *supra* note 30 and accompanying text, § 197 treats separately acquired patents and copyrights differently from those acquired as part of a trade or business. *See also* I.R.C. § 197(e)(4) (2012) (exempting certain intangibles "not acquired in a transaction . . . involving the acquisition of assets constituting a trade or business" from the fifteen-year depreciation rules).

184. As discussed *supra* note 146, usage of proven approaches counteracts the status quo bias against change.

185. *See supra* note 124.

proxy use of goodwill.[186] Fortunately, other developments have shown the ability to directly target the ultimate goal. Treaty-based sourcing rules now link right to the actual foreign taxation of the income. Importantly, these elective rules contain a viable anti-avoidance mechanism: a quid pro quo agreement to apply the foreign tax credit limitation separately to the elected foreign-source income. With the reform pathway already cleared, Congress can readily extend this tried and tested treaty approach to all intangibles gain.[187] Utilization of this proven structure neutralizes the status quo bias against untested proposals.

With these changes,[188] Congress would complete the worthwhile exercise undertaken in the foreign-subsidiary context. Trademarks typically generate positive consumer sentiments, creating the usual association of trademarks with goodwill.[189] But so-called badwill arises instead when the association with the trademark turns negative.[190] The proposed legislative changes here would eradicate the current "badwill hunting" association under the tax law and restore the appropriate "good" back into the positive goodwill attribute.[191]

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186. See the incisive quote from the recent preamble to the § 367 regulations *supra* note 65 and accompanying text.

187. See *supra* note 147 and accompanying text for the specifics of this change.

188. While this Article advocates for all of these changes, the independence of each change is another virtue. One particular change could be dropped, for instance, if the political process generated pushback in that area.

189. See *supra* notes 89–95 and accompanying text.

190. Aaron Perzanowski, *Unbranding, Confusion, and Deception*, 24 HARV. J. L. & TECH. 1, 10 (2010) ("[J]ust as brands can function as repositories of consumer goodwill, reflecting favorable public sentiment, they can also represent badwill, negative associations in the minds of consumers."); *id.* at 10 n.46 ("One way to conceptualize negative brand equity is to ask whether a consumer would prefer an unknown brand to a familiar one. A consumer who prefers a brand about which she has no information, other factors being equal, regards the known brand as a disincentive to purchase."); Randall B. Wilhite, *The Effect of Goodwill in Determining the Value of a Business in a Divorce*, 35 FAM. L.Q. 351, 353 n.11 (2001) ("A business might suffer from 'bad will' or . . . 'negative goodwill' . . . when the elements of a company come together and produce profits lower than what the same elements could produce separately. . . . There are some examples in Wall Street lore where 'corporate raiders' have bought a company, only to liquidate it on the notion that it is worth more dead than alive. Such a company is said to have had 'negative goodwill.'"); Note, *Badwill*, 116 HARV. L. REV. 1845, 1852–54 (2003).

191. Recall how goodwill generally references a business's positive reputation.