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Private Letter Ruling 79-05013*

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
[Code Sec. 167]

Depreciation; Deductibility; Year of sale; Liquidation v. transfer; Amount realized exceeds basis; Allocation of part of purchase price to goodwill.—CCH.

ISSUE

A. Whether, under the circumstances described below, the Service may reallocate the values assigned to land and other assets in the purchase of a business to reflect their relative fair market values and the existence of the intangible asset goodwill?

B. When using the "Formula Approach" to determine the value of goodwill, as outlined in Rev. Rul. 68–609, 1968–2 C.B. 327, how is the term "average annual value of tangible assets used in a business" defined; at what point or points in time should this value be computed?

FACTS

The taxpayer entered into an agreement to purchase from an unrelated seller a steel fabricating company. The purchase price was to be based on audited consolidated financial statements as of ***** subject to certain adjustments.

The District found that the facility's operating statements for a five year period immediately prior to the date in question were available for financial analysis. It was determined after study that the steel fabricating company, based upon past gross earnings and operating expenses, was capable of deriving a realizable profit over and above, reasonable expenses of operation of *****.

Based upon a net tangible asset value of ***** (tangible assets less applicable liabilities), intangibles would be computed as follows:

Average net earnings after taxes *****

Less: Normal earnings assigned to net tangible assets *****

Excess earnings assigned to intangible assets *****

Capitalizing these earnings *****

The District also concluded that the taxpayer made a bargain purchase of 2 of the 9 parcels of land purchased by the taxpayer. The District determined that the 2 parcels had a fair market value of ***** in excess of their purchase price.

APPLICABLE LAW

Section 1.167(a)–5 of the Income Tax Regulations provides that in the case of an acquisition of a combination of depreciable and nondepreciable property for a lump sum the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time.

Hoover, Owens, Rentschler, and Co., 9 BTA 1376 (1928), holds that the value of goodwill was determined by reference to the prior history of the business and its continued prosperity.

H & R Distributing Co., Inc., 31 T.C.M. 1014 (1972), holds that the Commissioner can determine that goodwill exists and can allocate part of the purchase price to it regardless of how the item is treated by the buyer and seller.

Rev. Rul. 68–609, provides that the "formula" approach may be used in determining the fair market value of intangible assets of a business only if there is no better basis available for making the determination; A.R.M. 34, C.B. 2, 31 (1920) 15 superseded.

Rev. Rul. 59–60, 1959–1 C.B. 237, defines the term "fair market value" as the price at which a property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

RATIONALE

With respect issue A, *H & R Distributing Co.*, and *Hoover, Owens, Rentschler, and Co.*, provide precedence of long standing in determining the rights of the Commissioner concerning the allocation of goodwill. The former case affirms the authority of the Commissioner to look at the allocation of values assigned to assets in the purchase price of a business and determine if goodwill exists regardless of how the items were treated by the buyer and seller. Even though the Commissioner may not disturb the aggregate purchase price for the entire business, the values of all assets including land may be reallocated in proportion to their fair market values to reflect their actual basis in the hands of the purchaser and determine the value of goodwill purchased, if any, as provided for by section 1.167(a)–5 of the regulations.

With respect to issue B. Rev. Rul. 68–609 addresses the determination of fair market value of intangible assets by the formula approach, and for this reason it is proper that all terms used in the formula be consistent. The formula uses value in terms of fair market value, so the term "average annual value of the tangible assets used in a business," in the formula, should be in terms of fair market values, as defined in Rev. Rul. 59–60.

CONCLUSION

It is proper for the Service to determine whether goodwill exists or not, and to reasonably allocate it as part of the purchase price. To accomplish this the Service may reallocate values set forth in a contract so as to reflect fair market value.