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THE CASE FOR PARITY BETWEEN TAX-EXEMPT AND NONEXEMPT PURCHASERS IN ASSET ACQUISITIONS*

D. Louis Glaser**

INTRODUCTION

When a buyer acquires the assets of a business, he generally will pay an amount which exceeds the aggregate fair market value of the tangible assets purchased. This excess usually represents a payment for the intangible assets of the business. The intangible assets may be either "identifiable," such as patents, copyrights, and noncompete agreements, or "unidentifiable," such as goodwill and going concern value.1

Goodwill and going concern value are not always present in asset acquisitions. If they are present, however, identifying the goodwill or going concern value within a business may be difficult, if not impossible. Furthermore, even if the buyer and seller are able to identify the presence of goodwill or going concern value, they may have great difficulty in arriving at a price for these intangible assets.

In July of 1988, the Treasury Department promulgated temporary regulations under section 1060 of the Internal Revenue Code (the "Code").2 The temporary regulations are an attempt to simplify the complex problems associated with valuing goodwill and going concern value in asset acquisitions.3 The temporary regulations abandon all attempts to derive a precise formula for valuing goodwill and going concern value in favor of a simple residual approach.4

Under the residual method, any amount the buyer pays in excess of the fair market value of the target business's identifiable assets automatically is classified as goodwill or going concern value. This can be problematic for

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1. See infra notes 23-30 and accompanying text (discussing a definition of goodwill and going concern value).
3. See S. REP. No. 313, 99th Cong., 2d Sess. 251, 254 (1986) ("[t]he mandatory application of the residual method is also warranted in view of the difficult and uncertain assumptions that are demanded by the application of the formula method and the excessive amount of conflict generated between taxpayers and the IRS concerning its application").
4. Id.
the buyer, to whom goodwill and going concern value are nondepreciable assets. The buyer is effectively "penalized" for paying an amount exceeding the fair market value of the identifiable assets by the acquisition of a nondepreciable asset. This is because the buyer loses depreciation deductions and, thereby, his ability to defer optimally his tax liability.

For a tax-exempt buyer, however, the acquisition and valuation of intangible assets present an even greater problem—the risk of losing its tax-exempt status. Traditionally, in the tax-exempt context, a formula method has been employed to value goodwill. The penalty for paying more than the formula amount for a target business's goodwill is that the exempt entity risks losing its tax-exempt status. The excess over the formula amount that accrues to a private individual is known as private inurement, and is prohibited under the Code. Thus, the penalty for misvaluing goodwill is more severe for a tax-exempt entity than it is for a nonexempt entity. As tax-exempt entities, especially hospitals, begin to expand into new businesses and compete with nonexempt bidders for a business's assets, the severity of this penalty may prevent exempt entities from effectively competing with nonexempt entities on the basis of price.

This Article proposes that tax-exempt and nonexempt entities face similar penalties for misvaluing goodwill. The Article will first examine asset acquisitions by nonexempt purchasers. In particular, the Article will focus on the acquisition and valuation of goodwill under the residual approach and the penalty associated with misvaluing goodwill. The Article then will examine asset acquisitions by tax-exempt purchasers. In doing so, the Article will discuss the proscription against private inurement and the limitations it places on an exempt entity's acquisition of the goodwill of a business. The Article then will discuss the traditional method of valuing goodwill in the tax-exempt context and the penalties associated with misvaluing goodwill. Next, the Article will show that the penalties faced by exempt entities are more severe than those faced by nonexempt purchasers, and that the difference in severity is unmerited. Finally, the Article will suggest two alternative solutions that would, if implemented, result in an equitable treatment of tax-exempt entities.

I. ASSET ACQUISITIONS BY TAXABLE ENTITIES

A. Introduction

The sale of the assets of an on-going business is a taxable event.\(^7\) The transaction, however, is not treated as the sale of one consolidated asset,
that is, the business as a whole. Instead, it is viewed as if the seller sold each business asset individually. As a result, the seller’s realized gain is determined by his aggregate basis in the business’s assets, and the characterization of his gain is determined by the character of the individual assets. If an asset qualifies as a capital asset, then the recognized gain attributable to the sale of that asset is characterized as capital gain. The recognized gain attributable to the sale of a noncapital asset results in ordinary income.

For example, assume S owns the assets of a business that is organized as a sole proprietorship. S’s aggregate basis in the assets is $2,000,000, and the aggregate fair market value of the assets is $4,500,000. Upon the sale of the sole proprietorship at a price of $4,500,000 in cash, S realizes a gain as if each asset had been sold separately. Absent a nonrecognition provision applicable to the sale, S recognizes the entire amount of realized gain. The amount of S’s recognized gain is, therefore, $2,500,000. The characterization of S’s gain as either capital gain or ordinary income depends on the character of the assets sold.

Prior to the Tax Reform Act of 1986, capital gains were taxed at a lower rate than ordinary income. As a result, the seller wanted more of the purchase price, and hence his recognized gain, attributed to the sale of the capital assets of the business. Following the Tax Reform Act of 1986, the seller’s concern with characterization is now diminished, because capital gains and ordinary income are taxed at the same rate. The seller, however,
still is concerned with the characterization of his gains if he possesses capital losses which, after the Tax Reform Act of 1986, can only be offset by capital gains.\(^7\)

The buyer of business assets is concerned primarily with paying the lowest price possible while still consummating the sale. Aside from the consideration paid, the buyer is concerned with obtaining basis in the depreciable assets.\(^8\)

Generally, a buyer's basis in an individually acquired, depreciable asset is determined by the price paid for the asset.\(^9\) The buyer then is able to depreciate or amortize his basis in the asset over the applicable recovery period.\(^10\) The resulting deductions for depreciation or amortization enable the buyer to defer taxes until a later date, thus saving him money.\(^11\)

### B. The Acquisition of Intangible Assets

The tax consequences of an asset acquisition are complicated by the presence of intangible assets in the acquired business. Intangible assets are "economic resources having no physical existence, their value being determined by the rights and other future benefits that possession confers."\(^12\)

Most intangible assets are not only more difficult to identify than tangible assets, they also are far more difficult to value.

Two commonly recognized intangible assets are goodwill and going concern value.\(^13\) Although sometimes viewed as interchangeable,

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17. I.R.C. § 1211(a) (Supp. IV 1986) ("losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges" or to the extent of capital gains plus $3,000 if the taxpayer is other than a corporation).

18. Toolson, Planning for the Purchase of Intangibles in Business Acquisitions, 12 REV. OF TAX'N OF INDIVIDUALS 326, 327 (1988). For an asset used in a trade or business to be depreciable, it must be a wasting asset. For the limitations on depreciation, see I.R.C. §§ 167, 168 (Supp. IV 1986); Treas. Reg. § 1.167(a) (1977).

19. I.R.C. § 1012 (Supp. IV 1986) ("basis of property should be cost of such property").

20. I.R.C. § 168(c) (Supp IV 1986).

21. The depreciation deductions offset the buyer's income in the year of the deduction. See I.R.C. § 167(a) (Supp. IV 1986). Assuming a 34% tax rate, for one dollar of depreciation taken in the current year the buyer saves $0.34 in taxes. The buyer's basis is adjusted downward to reflect the depreciation taken. See I.R.C. § 1016(a)(2) (Supp. IV 1986). Therefore, when the buyer sells the depreciated assets in a subsequent year, the buyer's taxable income will be increased by the amount of depreciation taken in previous years (provided that the assets retain their value). The buyer, thus, is able to defer tax liability until future years, and save money due to the depreciation deductions. Because of the time value of money, the amount of tax savings attributable to depreciation should be discounted to present value. Thus, the buyer saves an amount, \(C\), in taxes due to depreciation deductions equal to:

\[
C = \left\{(D_1 \times R) \times (1 + i)^{-n} + (D_2 \times R) \times (1 + i)^{-n} + \ldots + (D_n \times R) \times (1 + i)^{-n}\right\}
\]

where:

- \(n\) = year
- \(D_n\) = allowable depreciation deduction for the year
- \(R\) = applicable tax rate
- \(i\) = applicable annual discount rate


23. Other examples of intangible assets are: patents, copyrights, trademarks, franchises, royalty
able,\textsuperscript{24} these two intangible assets are distinct. Goodwill generally is associated with the reputation of a business and its customer loyalty.\textsuperscript{25} A payment for goodwill reflects the buyer's belief that customers will continue to frequent the business after a change in ownership.\textsuperscript{26} The Supreme Court similarly has defined goodwill as the "value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business."\textsuperscript{27}

Going concern value, on the other hand, is not associated with the expectation of continued patronage. Going concern value is "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern."\textsuperscript{28} The Supreme Court, in a series of cases, recognized a difference between going concern value and goodwill.\textsuperscript{29} The Court has stated that going concern value is:

\begin{quote}
'A[n element of value in an assembled and established plant, doing business and earning money, over one not thus advanced,' and that this element of value is a 'property right' which should be considered
\end{quote}

and license agreements, customer lists, noncompete agreements, and secret formulas. \textit{Id.} Unlike the intangible assets enumerated above, goodwill and going concern value are unidentifiable and cannot be separated from the business as a whole. \textit{Id.}

\textsuperscript{24} See Wiener, \textit{Going Concern Value: Goodwill by Any Other Name?}, 33 \textit{Tax Law.} 183, 184 (1979).

\textsuperscript{25} I. \textsc{Blackman}, \textsc{Valuation of Privately-Held Businesses} 121 (1986). Goodwill is defined as follows:

\begin{quote}
\[\text{Diff}erence \text{between the value of a business' [sic] net assets—both tangible and intangible, but excluding goodwill—and the price that a willing buyer would pay for the business as a whole. Generally, this difference reflects the expectation that a business will maintain customer patronage, and as a result, will generate a reasonable rate of return after the buyer assumes ownership. It is a value that comes from the favorable reputation arising out of an established, well-known, and well-conducted business.}\]
\end{quote}

\textit{Id.}

\textsuperscript{26} \textit{Id.}

\textsuperscript{27} \textit{Los Angeles Gas & Elec. Corp. v. Railroad Comm'n}, 289 U.S. 287, 313 (1933). See also \textit{Metropolitan Bank v. St. Louis Dispatch Co.}, 149 U.S. 436, 446 (1893) (goodwill is the "advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence"); \textit{Boe v. Commissioner}, 307 F.2d 339, 343 (9th Cir. 1962) ("the essence of goodwill is the expectancy of continued patronage").

\textsuperscript{28} \textit{VGS Corp. v. Commissioner}, 68 T.C. 563, 591 (1977). See also I. \textsc{Blackman}, \textit{supra} note 25, at 123 (going concern value is represented by the "ability of a business to continue to function and generate income without interruption as a consequence of a change in ownership and management").

in ‘determining the value of the property’ . . . . The going value thus recognized is not to be confused with good will. . . .

Although the courts have distinguished between goodwill and going concern value, the tax consequences of purchasing either one are generally the same. Both goodwill and going concern value are nondepreciable assets. An allocation of the purchase price to goodwill or going concern value does not result in the same deferral benefits as an allocation to a depreciable asset. The incentive, therefore, is for the buyer and seller to allocate as much of the purchase price as possible to depreciable or amortizable assets. The Code, however, imposes strict restrictions on the allocation of consideration to the assets purchased. These restrictions are not intended solely to restrict allocation to depreciable assets, but also to avoid the problems associated with valuing goodwill and going concern value.

30. Los Angeles Gas & Elec. Corp., 289 U.S. at 313 (quoting Des Moines Gas Co. v. Des Moines, 238 U.S. 153, 165 (1915)). See also Concord Control, Inc. v. Commissioner, 35 T.C.M. (CCH) 1345 (1976), aff'd, 615 F.2d 1153 (6th Cir. 1980). In Concord, the Commissioner determined that the acquiring corporation had improperly failed to allocate a part of its purchase price to goodwill. Id. at 1355. The tax court found that the acquiring corporation could not expect continued patronage or a continued competitive advantage. Id. at 1355. The tax court noted that “[a] precondition to the possession of transferable goodwill is a finding that the seller’s business is of such a nature as to provide the purchaser with the expectancy of both continuing excess earning capacity and competitive advantage or continued patronage.” Id. at 1355. The tax court noted that “going concern value . . . as distinguished from goodwill, is the increase in the value of assets due to their existence as an integral part of an ongoing business.” Id. The tax court concluded that the assembled assets in an ongoing business resulted in the presence of going concern value even in the absence of goodwill. Id. See also Black Indus. v. Commissioner, 38 T.C.M. (CCH) 242 (1979) (“any assemblage of assets into a functioning, on-going business is capable of giving rise to going-concern value”); VGS Corp., 68 T.C. at 592 (1977) (finding of going concern value in absence of goodwill because the acquired business was a “viable, functioning, and going concern capable of generating a profit”).

31. See Toolson, supra note 18, at 328 (“a practical distinction between goodwill and going-concern value . . . is no longer relevant . . . in either case, the result is a nonamortizable asset”).

32. For authority on the nondepreciable nature of goodwill, see Treas. Reg. § 1.167(a)-3 (1977). For authority on the nondepreciable nature of going concern value, see Northern Natural Gas Co. v. United States, 470 F.2d 1107, 1109 (8th Cir. 1973) (“the basis for depreciation of a purchaser of a going concern should not include the ‘enhanced’ portion of the acquired assets’); Cornish v. United States, 348 F.2d 175, 185 (9th Cir. 1965) (“it is not within the meaning of Section 167 of the Code to allow taxpayers to recoup the cost they paid for the going concern value through an increased depreciation base on the tangible assets”).

33. See infra note 30 and accompanying text.

34. If the seller is able to allocate the purchase price in a manner which provides the buyer with tax savings, the buyer may increase the purchase price. For example, if the buyer obtains an additional $1,000 in tax savings due to deductions, the seller may convince the buyer to increase the purchase price by $500, thus sharing the benefit of the additional deductions.
C. The Residual Method of Allocating Purchase Price to Tangible and Intangible Assets

Section 1060 of the Code controls the allocation of a buyer's basis among the assets acquired in an "applicable asset acquisition." An applicable asset acquisition is any transfer of assets if the assets constitute a trade or business in the hands of the seller, and the buyer's basis in the acquired assets is determined wholly by reference to the consideration paid.

In July of 1988, the Treasury Department promulgated temporary regulations under section 1060. The temporary regulations employ a "residual method" for determining the buyer's basis in the acquired assets, both tangible and intangible. The residual method requires the categorization of the acquired assets into one of four classes. Class I assets are "cash, demand deposits and like accounts in banks, savings and loan associations . . . and other similar items." Class II assets are "certificates of deposit, U.S. government securities, readily marketable stock or securities . . . foreign currency, and other items designated in the Internal Revenue Bulletin." Class III assets are "all assets (other than Class I, II, and IV assets), both tangible and intangible (whether or not depreciable, depletable, or amortizable), including furniture and fixtures, land, buildings, equipment, accounts receivable, and covenants not to compete." Class IV assets are "intangible assets in the nature of goodwill and going concern value."

The residual method requires the buyer and seller to allocate the consideration paid for the acquired assets in the following manner. First, the purchase price is reduced by the amount of Class I assets transferred by the seller. The remaining amount of consideration then is allocated to the Class II and Class III assets transferred by the seller in proportion to their fair market values. Any amount remaining after reducing the purchase price by the allocations to Class I, II, and III assets is allocated automatically to Class IV assets.

For example, assume that S owns business assets with an aggregate basis of $2,000,000. The fair market value of all assets, excluding good-

36. Id. § 1060(c)(1).
37. Id. § 1060(c)(2).
39. The residual method refers to the manner in which allocations are made to goodwill and going concern value. See infra notes 40-46 and accompanying text.
41. Id. § 1.1060-1T(d)(2)(i).
42. Id. § 1.1060-1T(d)(2)(ii).
43. Id. § 1.1060-1T(d)(2)(iii).
44. Id. § 1.1060-1T(d)(1).
45. Id. § 1.1060-1T(d)(1)-(2).
46. Id. § 1.1060-1T(d)(2).
will and going concern value, equals $4,500,000. Assume further that a buyer is willing to pay $5,000,000 for the business. Employing the residual method of section 1060, the purchase price is reduced by the cash transferred to the buyer. The remaining amount is allocated among the Class II and Class III assets transferred in proportion to their fair market values. The remaining or residual amount, in this case $500,000, automatically is classified as goodwill or going concern value.

The result of paying a purchase price in excess of the identifiable assets, both tangible and intangible, is that the buyer acquires nondepreciable goodwill or going concern value. The buyer has expended additional capital, and is prevented from recovering the amount through the use of depreciation. The buyer has lost the benefit of deferring tax liability, but has obtained basis in the goodwill. When the buyer sells the business, the buyer will offset the amount realized from the sale of the goodwill with his basis in the goodwill. The buyer's actual cost of acquiring nondepreciable goodwill is, therefore, somewhat less than the cost of the foregone depreciation.

D. IRS Challenges to an Allocation and the Penalties Associated with an Increase in the Amount of Class IV Assets

When allocating the purchase price among the Class II and III assets, the temporary regulations restrict the amount allocable to any asset to the fair market value of that asset on the date of purchase. The IRS is

47. In other words, the $4,500,000 represents the fair market value of the Class I, II, and III assets of the business. See supra text accompanying notes 40-42 for a description of Class I, II, and III assets.

48. See supra note 32 and accompanying text (discussing nondepreciable nature of goodwill).

49. See infra note 50 and accompanying text.

50. The buyer is able to defer tax liability until future years and save money due to the depreciation deductions. Because of the time value of money, the amount of tax savings attributable to depreciation should be discounted to present value. Assuming that a buyer could depreciate the goodwill over n years, the cost, C, to the buyer of the lost depreciation is determined by discounting the present value of the lost depreciation deductions. See supra note 21 (describing formula for discounting present value). A buyer's total cost of purchasing the goodwill, however, is reduced by his basis recovery upon the sale of the goodwill. Assuming the buyer sells the business in year y (which occurs after year n), and that the buyer's amount realized on the sale of the goodwill is equal to an amount which exceeds his basis, B, the buyer's total cost is equal to:

$$\text{Total Cost} = C - [(B \times R) \times (1 + i)^{-y}]$$

where: R = applicable tax rate
i = applicable annual discount rate

51. Temp. Treas. Reg. § 1.1060-1T(e)(1) (1988). The temporary regulations also require the buyer and seller to file forms revealing their allocation among assets acquired in a qualified asset acquisition. Id. § 1060-1T(h)(2). Although the amount allocated to any one depreciable asset cannot exceed the asset's fair market value, there is a certain amount of leeway in determining
free to challenge the buyer and seller's determination of the fair market value of any asset and the allocation of purchase price to that asset.\(^5\) If the IRS determines that the buyer and seller's calculation of an asset's fair market value is too high, then the excess over the IRS's determination of fair market value automatically is classified as a Class IV asset.\(^3\)

For example, assume again that \(S\) is selling the assets of a business with an aggregate basis of $2,000,000. Assume further that the buyer pays $5,000,000 for the assets and that the buyer and seller attempt to allocate $4,800,000 to the Class I, II, and III assets. Under this allocation scheme, the buyer obtains only $200,000 of nondepreciable goodwill or going concern value. Now assume that the IRS challenges the allocation and determines that the fair market value of the Class I, II, and III assets is $4,500,000. The residual method reclassifies the difference between the IRS's determination and the buyer and seller's determination ($300,000) as goodwill or going concern value.

The result of the challenge is that the difference between the IRS's determination and the buyer and seller's determination of fair market value automatically is classified as nondepreciable goodwill or going concern value. Thus, the penalty for a buyer of allocating purchase price over and above the fair market value of an identifiable asset is that the amount will be nondepreciable goodwill. This cost is mitigated, however, because the buyer will be able to offset the amount of consideration he receives in a subsequent sale of the business by the amount of his basis. Thus, the actual cost of over-allocating again is less than the amount of the actual over-allocation.\(^5\)

II. Asset Acquisitions By Tax-Exempt Entities

Asset acquisitions by tax-exempt entities\(^5\) generally involve the same issues as acquisitions by nonexempt entities. The seller is concerned primarily with the amount of money it receives after taxes, and is concerned somewhat with the characterization of its gain.\(^5\) Asset acqui-

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\(^5\) Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders \(\S\) 11.11 (5th ed. 1987). Ascertaining the fair market value of an asset is not a precise calculation. Id. There exists a range in which a value may be accepted as representing fair market value. Toolson, supra note 18, at 327. The buyer, therefore, still has some flexibility in allocating a portion of the purchase price to depreciable assets. Because the seller generally is not concerned with the characterization of his gain, the seller should be receptive to the buyer's allocation scheme. See supra note 16 and accompanying text (after the Tax Reform Act of 1986, seller not as interested in character of gain).


\(^3\) Id. \S 1.1060-1T(d)(2).

\(^5\) See supra note 50 and accompanying text (discussing time value of depreciation deduction).

\(^5\) See infra notes 58-60 and accompanying text (discussing the definition of a tax-exempt entity).

\(^5\) See supra notes 16-17 and accompanying text (interest is diminished after change in tax laws).
itions by tax-exempt entities, however, entail one additional factor to consider. A tax-exempt acquiring entity must structure the asset acquisition so as not to jeopardize its exempt status.\textsuperscript{57} To see how and why an exempt entity must protect its tax-exempt status in structuring an asset acquisition, it is necessary to examine the restrictions placed on an the entity by virtue of its exempt status.

\subsection*{A. The Requirements for Exempt Status}

Section \textsection{501(c)(3)} of the Code exempts \textquoteright{}organizations . . . organized and operated exclusively for . . . charitable purposes\textquoteright{} from income taxation.\textsuperscript{58} In order to meet the requirements of Section \textsection{501(c)(3)}, an entity must satisfy both an organizational test and an operational test.\textsuperscript{59} An entity's failure to meet either of the tests results in a loss of tax-exempt status.\textsuperscript{60}

The Code also mandates that \textquoteright{}no part of the net earnings . . . inures to the benefit of any private shareholder or individual\textquoteright{} from the exempt organization.\textsuperscript{61} This express prohibition is further explained by the operational test of the Treasury Regulations.\textsuperscript{62} The Treasury Regulations state that \textquoteright{}[a]n organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.\textquoteright{}\textsuperscript{63} Thus, an entity that permits private inurement to occur violates both the express language of the Code and the operational test. When the violation occurs, the entity loses its tax-exempt status.\textsuperscript{64}

Although the Code and the Treasury Regulations expressly forbid private inurement, neither provides a precise definition of private inurement. Instead, the rationale behind prohibiting private inurement pro-
vides some indication of the actual definition. The purpose for the proscription is to ensure that the exempt entity serves public rather than private interests. When more than an incidental amount of private inurement occurs, private interests are being served. For example, private inurement may occur in a payment of the exempt entity's earnings, such as a dividend, to an individual, when unreasonably high compensation is paid by the exempt entity, or when low interest loans are made to persons associated with the exempt entity.

B. Limitations on Tax-Exempt Buyers in Asset Acquisitions

The purchase of the assets of an ongoing business by a tax-exempt entity creates the potential for private inurement. The problem associated with the transaction is that if more than fair market value is paid for the business, a private individual may be receiving tax-exempt funds in excess of what is reasonable. The concern is intensified when the parties negotiating the transaction are related, or when one party controls

65. See Rev. Rul. 76-206, 1976-1 C.B. 154, 155 ("[a]lthough an incidental private benefit will not destroy [exempt status], where an organization is serving both public and private interests the private benefit must be clearly incidental to the overriding public interest") (citing Ginsburg v. Commissioner, 46 T.C. 47 (1966)).

66. Id.

67. See P. TREUSCH & N. SugARMAN, Tax-Exempt Charitable Organizations 134-36 (1979). This does not mean that private inurement follows whenever a private individual benefits or receives remuneration from an exempt entity. The Code and the Treasury Regulations both prohibit the inurement of an exempt entity's "net earnings." I.R.C. § 501(c)(3) (Supp. IV 1986); Treas. Reg. § 1.501(c)(3)-1(c)(2) (1976). The term "net earnings" refers to gross earnings less reasonable expenses. P. TREUSCH & N. SUGARMAN, supra, at 133. Reasonable expenses include "ordinary and necessary expenses of the [exempt] organization or reasonable capital outlays, such as . . . the purchase price of property realized by way of sale." Id. Implicit in this definition is the notion that an exempt entity's payment of money to a private individual for a reasonable expense does not result in private inurement. Id. On the other hand, the payment to a private individual of an amount exceeding what is reasonable almost certainly results in private inurement. Id. An exempt entity's isolated transactions may violate the private inurement proscription. For example, the following transactions may involve private inurement, because the potential for a private individual to receive more than a fair value for the goods or services transferred or sold to or by the exempt entity exists in each one:

1) the sale, or exchange or leasing of property between an exempt entity and a private individual at a price greater than fair market value;
2) the lending of money to a private individual at below market rate loans;
3) the furnishing of free goods or services by an exempt entity to a private individual;
4) the payment of excessive compensation by an exempt entity to a private individual; and,
5) the transfer of income or assets from an exempt entity to a private individual.


68. B. HOPKINS, supra note 67, at 217.
the other. In this situation, the IRS's concern is that the purchase price paid for the assets will not be negotiated at arm's length. If not at arm's length, the purchase price is presumed to be greater than fair market value, and private inurement occurs.

For example, assume that a physician who is on staff at a hospital sells his practice to the tax-exempt hospital. Assume further that the fair market value of all of the practice's assets is $500,000. The hospital can pay no more than $500,000 for the assets of the practice without violating the private inurement proscription. If the hospital pays a price greater than $500,000, and it is challenged by the IRS, the hospital risks losing its tax-exempt status.

In the given example, it is relatively simple for the hospital to avoid private inurement because the fair market value was given. In reality, however, the fair market value of assets in a business is not easily determined. Most assets are saleable, and their fair market value can be determined readily. Some assets, however, are not saleable and no ready market exists for their disposal. The determination of the fair market value of these assets is sometimes reduced to mere speculation. Such is the case with the intangible assets of a business. Acquisitions involving intangible assets create new problems for tax-exempt buyers because intangible assets are so difficult to value.

C. Acquisitions of Goodwill by Tax-Exempt Entities

Historically, the IRS has taken an approach to valuing goodwill in the tax-exempt context that differs from the residual method. An early General Counsel Memorandum ("GCM") examined the effect on an entity's tax-exempt status of acquiring goodwill from a proprietary entity. The GCM was a response to the IRS's claim that the issue presented

70. Id.
71. Id.
72. The exempt entity, however, should attempt to identify all of the tangible and intangible assets of the business it is acquiring. In the example, the exempt hospital may acquire intangible assets such as patient lists or it may obtain a noncompete agreement with the physician. In addition, the hospital may wish to retain the physician in either a consulting role or as an employee. In these cases, the exempt hospital may pay the physician for the reasonable value of the intangible assets and for the reasonable value of his services. The hospital, however, must be aware of the private inurement problems that are presented by these arrangements.
73. An exempt entity may obtain a third-party appraisal of the value of these assets. Although the appraisal may aid the exempt entity in establishing fair market value, the IRS still may challenge the valuation.
74. Gen. Couns. Mem. 34,256 (Jan. 22, 1970). The GCM presented five questions concerning the purchase of goodwill:
1) Is there any basis in the Code, regulations, or case law for denying exemption under section 501(c)(3) to a nonprofit organization solely because it purchases goodwill attached to assets intended for use in its exempt activities?
itself in situations where an exempt entity desired to purchase the assets of a nonexempt business with the intent of continuing the business in nonprofit form.\textsuperscript{79}

The GCM stated that "a charitable organization's purchase of goodwill in connection with the other assets of a going concern intended for use in its exempt activities, does not, per se, preclude the exemption of the acquiring organization."\textsuperscript{76} The GCM further noted that exemption is lost only when the purchase price is unreasonable and in excess of fair market value.\textsuperscript{77} After examining both commentators' writings and judicial opinions, the GCM concluded that the capitalization of excess earnings method generally was employed.\textsuperscript{78} The GCM, however, noted that the situations in which goodwill could be found using the capitalization method would be rare.\textsuperscript{79} The GCM stated that:

\begin{quote}
There may be reasons why a goodwill factor valued on the capitalization of excess earnings method would not be worth much to such a buyer. We are aware of no way, however, in which the value of an intangible asset like goodwill can be established except by reference to superior earning power and certainly it appears to be most commonly measured and valued, at least in a wholly commercial context, by a capitalization of excess earnings.\textsuperscript{80}
\end{quote}

The GCM concluded that compelling reasons exist for purchasing an ongoing business and, therefore, if a substantial amount of goodwill is attached to the business an exempt entity should not be prohibited from making the acquisition.\textsuperscript{81}

2) Assuming that no more than the fair market value of the goodwill is paid, is the answer to question (1) the same where the transaction is not at arm's length, i.e., the sellers control the buyer nonprofit organization?

3) If a nonprofit organization is permitted to purchase goodwill attached to assets intended for use in their exempt activities, is there any method of determining the value of the goodwill which is more appropriate to the operation of an exempt organization than the method based on the capitalization of the proprietary institution's excess earning capacity?

4) Can an exempt organization purchase the goodwill resulting from the operation of a professional practice, such as that of a proprietary medical clinic?

5) If there does not exist a valid legal means of attacking the purchase of goodwill by controlled nonprofit education and health organizations, is it feasible to recommend legislation directed either at the purchaser's exemption or the seller's capital gains treatment to prevent this abusive use of existing tax law?

\textit{Id.}

75. \textit{Id.}

76. \textit{Id.}

77. \textit{Id.}

78. \textit{Id. See infra} notes 89-94 (discussion of the capitalization of excess earnings method).


80. \textit{Id.}

81. \textit{Id. The GCM noted that "there may well be compelling reasons why \ldots it would be more feasible, economical, perhaps even necessary, to purchase a going facility for use in its exempt programs rather than \ldots attempt the planning and construction of the facility." \textit{Id.}
The IRS has permitted exempt hospitals to acquire goodwill without finding a violation of the private inurement proscription under very narrow circumstances. In Revenue Ruling 76-91,82 a tax-exempt hospital requested a ruling on whether its purchase of the assets of a for-profit hospital, including a payment for goodwill, resulted in private inurement. The acquiring hospital established the purchase price by obtaining an independent appraisal of the seller's tangible assets.83 The value of the intangible assets, which proved substantial, was computed by the capitalization of excess earnings formula.84

The IRS noted that a presumption exists that the price paid for assets from an independent third party represents fair market value.85 The IRS further noted that this presumption does not exist when the seller controls the purchaser or when a close relationship exists between the two parties.86 The IRS stated that when the presumption does not exist, the purchaser must:

1) establish the components of the intangible assets;
2) indicate how these components will be used to further the purchaser's exempt purpose; and,
3) establish the aggregate value of the intangible assets using the capitalization of excess earnings formula.87

The IRS concluded that because the acquiring hospital had followed these steps, the purchase of the intangible assets did not result in private inurement.88

D. The Capitalization of Excess Earnings Method and Its Penalties

The capitalization of excess earnings method referred to by the GCM and Revenue Ruling 76-91 originally was known as the ARM method.89 An example best demonstrates how the confusing capitalization of excess earnings computation works. Assume that a business being purchased had the following net earnings for the five years preceding the acquisition:

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82. 1976-1 C.B. 149.
83. Id. at 150.
85. 1976-1 C.B. at 150.
86. Id. The IRS stated that "the elements of an arm's length transaction are not present" when such a relationship exists. Id.
87. Id.
88. Id.
The target business's tangible assets are valued, and a percentage return expected from a business with tangible assets of comparable size is selected. Assume that a comparable business generates a return of 8.125% and that the value of the target's tangible assets is $2,000,000. The percentage return is multiplied by the value of the target's tangible assets, resulting in an average annual return on the tangible assets of the target equal to $162,500. This amount then is subtracted from the target's average annual return, resulting in a figure of $37,500, representing the target's excess return due to goodwill.

Next, a capitalization rate is determined. The capitalization rate is based on the target's position in its industry. Assume that this rate is 15%. The difference between the target's average annual return and the industry average is then capitalized by dividing the amount ($37,500) by the above determined capitalization rate (15%). In the above example, this final amount is equal to $250,000. This amount represents the goodwill in the target business. As a result, in order to avoid private inurement and to maintain its tax-exempt status, the exempt entity can pay only $2,250,000 for the target business.

III. THE DISPARATE TREATMENT OF TAX-EXEMPT ENTITIES

The IRS's historical treatment of an exempt entity's acquisition of goodwill differs from the residual method found in the temporary re-

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90. This value may be computed by an appraisal. See Concord Control, Inc. v. Commissioner, 78 T.C. 742 (1982). This step introduces an element of inaccuracy in trying to value the tangible assets. See Henszey, Going Concern Value After Concord Control, Inc., 61 Taxes 699, 704 (1983).

91. In one case, the comparable return was determined by looking at data from IRS statistics on corporate tax returns. This step again introduces inaccuracy and uncertainty into the capitalization of excess earnings computation. Henszey, supra note 90, at 704-05.


93. See supra notes 90-92 and accompanying text for a discussion of the problems associated with the capitalization of excess earnings method.

94. If other intangible assets are present in the business, they may be purchased for an amount equal to their fair market values.
gulations under section 1060. Under the capitalization of excess earnings method, a ceiling is placed on the amount an exempt entity can pay for the assets of a business. This ceiling is represented by the fair market value of the business's identifiable assets plus an amount equal to the capitalized value of the business's superior earning power. If the business has no superior earnings power, the tax-exempt entity cannot pay an amount exceeding the fair market value of the identifiable assets of the business. The penalty for paying more is the loss of the entity's tax-exempt status.

The residual method does not limit a nonexempt entity in a similar manner. There is no limit to the amount a nonexempt entity can pay for a business except the buyer's capital resources. In addition, a nonexempt entity is not constrained by the earnings power of the target business when valuing goodwill. The nonexempt buyer is penalized for paying a price that exceeds the value of goodwill determined under the residual method. The penalty, however, is only that the buyer loses depreciation deductions on account of obtaining nondepreciable goodwill.

The disparate treatment, created by the different methods of valuing goodwill under the residual method and the capitalization of excess earnings method, is most evident when a nonexempt entity and an exempt entity are bidding for the same business. For example, assume that both an exempt entity and a nonexempt entity are competing for the assets of a particular business. Assume further that the value of the business's goodwill determined under the capitalization of excess earnings method is equal to $100,000.

Using the analysis set forth in Revenue Ruling 76-91, the most the tax-exempt entity could pay for the assets and goodwill would be the fair market value of the business's identifiable assets plus $100,000. Any price greater than this may result in private inurement and the loss of the entity's tax-exempt status. The nonexempt bidder, however, is not limited in the amount it can pay. The nonexempt entity, especially if it is aware of the exempt entity's bid, can offer an amount exceeding $100,000 for the goodwill of the business. The highest of the two bids, the bid by the nonexempt entity, will be accepted because the seller is most concerned with the amount of after-tax consideration he receives.

Both entities are penalized under this example if they pay amounts exceeding the fair market value of the business's goodwill as determined

95. I.R.C. § 1060 (Supp IV 1986). Section 1060 applies solely to asset acquisitions. An analogy between section 1060 and an exempt entity's stock acquisition, however, would also be in order. In the case of an exempt entity's acquiring the stock of a target corporation, the IRS looks at the target's assets to determine whether the purchase price violates the private inurement proscription. See Harding Hosp., Inc. v. United States, 505 F.2d 1068, 1071-77 (6th Cir. 1974). Therefore, if a premium were paid in a stock acquisition, it is reasonable to assume that the premium would also be subject to scrutiny under the capitalization of excess earnings method.

96. See supra note 50 and accompanying text (time value of depreciation explained).
by the capitalization of excess earnings method. If the exempt entity pays an amount greater than the fair market value of the assets, it risks losing its exempt status. If the exempt entity, however, does not match the nonexempt entity’s bid, the exempt entity is unable to complete the purchase. As for the nonexempt entity, the penalty for paying a price that exceeds the fair market value of the business’s assets is an increase in nondepreciable goodwill. This penalty, however, does not prohibit the nonexempt entity from completing the purchase. As long as the nonexempt entity can afford to pay the additional consideration, the acquisition can still go through.

The resulting penalty, therefore, is more severe in the case of an exempt entity. An exempt entity is faced with a choice of either paying the additional consideration and risking the loss of its exemption, or submitting a lower offer than a nonexempt competing bidder and risking loss of the acquisition. The inequity in such a situation is that the fair market value of a business is the price that a buyer is willing to pay and a seller is willing to accept, both knowing the relevant facts and both without compulsion. In the transaction described above, the nonexempt entity’s bid represents this notion of fair market value. The exempt entity, however, is unable to match the bid without risking the loss of its exempt status because of the limitations placed on the price it can pay for goodwill. The exempt entity, therefore, is prohibited from paying what is truly the fair market value of the business.

IV. SOLUTIONS

A. Applying the Residual Method to Acquisitions by Exempt Entities

One solution to enable exempt entities to compete on the same level as nonexempt entities when purchasing the assets of a business is to accord exempt entities residual method treatment. The residual method of section 1060 applies to all “applicable asset acquisitions” and, therefore, could be read as applying to a tax-exempt entity’s acquisition of a business’s assets. The result is that the residual method of allocating

97. Nonexempt entities may argue that exempt entities possess an advantage by virtue of their exempt status and, therefore, that the disparity in treatment is unworthy of concern. Other mechanisms, however, are in place that eliminate any advantage an exempt entity may have. One such example is the tax on unrelated trade or business income. See I.R.C. §§ 511-513 (Supp. IV 1986). In addition, it may be argued that tax exemption only marginally advantages an exempt entity when competing against a nonexempt. See Comment, Unrelated Trade or Business Income and Hospitals: Reconciling Operating Losses and Charity Care, 19 Loy. U. Chi. L.J. 1307, 1319-23 (1988).

98. See Jack Daniels Distillery v. United States, 379 F.2d 569, 574 (Ct. Cl. 1967) (purchaser’s fair market value of Jack Daniels whiskey depended upon the use of the right to market the whiskey under the Jack Daniels label, the use of which is an intangible in the valuation of a tangible asset).

the purchase price to goodwill would apply instead of the capitalization of excess earnings method. The target business’s excess earnings capacity, therefore, would no longer limit the price an exempt entity could pay for the target’s goodwill.

Analyzing an exempt entity’s asset acquisitions under the residual method would enable the exempt entity to compete with nonexempt bidders. When competition is present from another bidder, residual method treatment would permit an exempt entity to raise its purchase price, thereby matching a competing bid from a nonexempt bidder without the threat of losing its exempt status. The amount of consideration that exceeds the fair market value of the identifiable assets automatically would be classified as goodwill.

The use of the residual method in this situation also enables an exempt entity to pay what another nonexempt buyer is willing and able to pay. Assuming the bidders are competing fairly on price, the purchase price is being negotiated at arm’s length. In such a situation, the exempt entity should be able to increase its bid without violating the private inurement proscription. Denying an exempt entity the opportunity to complete a purchase that is negotiated at arm’s length should not be the aim of the capitalization of excess earnings method and the private inurement proscription. As stated above, the IRS has stated that a presumption exists that an independently negotiated purchase price presumptively represents fair market value. The same presumption should exist when entities enter competing bids, regardless of the entities’ tax status.

When competition is not present, the general proscription of the temporary regulations would operate to prevent the exempt entity from paying more than a reasonable amount for the goodwill of the target business. If, however, the purchase price was negotiated at arm’s length between the seller and the exempt buyer, a presumption should operate to determine that the amount paid is not in excess of fair market value.

An exempt entity, however, would not be penalized for acquiring the additional nondepreciable goodwill. The additional goodwill and the corresponding loss of the depreciation deductions would not cost the

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101. Temp. Treas. Reg. § 1.1060-1T(e)(1) (1988). The IRS is free, under the temporary regulations, to challenge a determination of the value of goodwill. For example, in the nonexempt context, assume that S owns the assets of a business with a fair market value, including goodwill, of $5,000,000. Assume that S’s father (F) purchases the assets from S for $10,000,000, and an allocation of $6,000,000 is made to goodwill. Under the temporary regulations, the IRS is free to challenge S and F’s allocation to goodwill. The IRS may determine that the fair market value of the goodwill transferred is $1,000,000, and that the additional $5,000,000 is a gift.

Similarly, the IRS could challenge a determination of the value of goodwill purchased by an exempt entity, with the threat of denying tax-exempt status. The exempt purchaser will face a more difficult task in demonstrating that the price paid for the goodwill was reasonable; however, the entity should be permitted to substantiate its determination.
exempt entity as much as it would cost a nonexempt entity because of the tax exemption.

It is unlikely that this was the intended result of section 1060. The committee report on the temporary regulations states that the use of the residual method was not intended to restrict the IRS's ability to determine fair market value by any appropriate method.\textsuperscript{102} The temporary regulations state that "[t]he amount of consideration allocated to an asset is subject to any applicable limitations under the Code or general principles of tax law."\textsuperscript{103} In addition, the temporary regulations state that the IRS may challenge a taxpayer's determination of the fair market value of any asset, including goodwill and going concern value.\textsuperscript{104}

In light of section 1060's reservation of the right to challenge a taxpayer's method of valuation, it appears that the residual method was not meant to apply to exempt entities in all situations. In addition, the application of section 1060 in all asset acquisitions would leave the IRS without a strong check on private inurement violations in sales in which the exempt entity is the only bidder.

\textbf{B. Recognizing the Distinction Between Goodwill and Going Concern Value}

An alternative solution is to recognize and permit the acquisition of going concern value by exempt entities. The courts have carefully distinguished between goodwill and going concern value prior to the promulgation of the temporary regulations under section 1060.\textsuperscript{105} With the promulgation of the temporary regulations, however, the IRS seems willing to permit the delicate distinctions to vanish because of the difficulty in valuing goodwill and going concern value. This may be appropriate where the effect of acquiring goodwill is the same as acquiring going concern value. This, however, is not the case with exempt entities.

Cases or rulings concerning an exempt entity's acquisition and valuation of going concern value do not exist. The IRS seems to ignore the presence of going concern value in acquisitions by exempt entities in spite of one commentator's suggestion that going concern value is present

\textsuperscript{102} S. REP. No. 313, 99th Cong., 2d Sess. 251 (1986).


\textsuperscript{104} Id. § 1.1060-1T(e)(4). The temporary regulations state:

\begin{quote}
In connection with the examination of a return, the Internal Revenue Service may challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties. For example, in certain cases the Internal Revenue Service may make an independent showing of the value of goodwill and going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets.
\end{quote}

\textit{Id.}

\textsuperscript{105} See \textit{supra} notes 28-30 and accompanying text (defining going concern value and goodwill).
The IRS has focused exclusively on goodwill and the capitalization of excess earnings method, in spite of GCM 34,256's insistence that the valuation of goodwill on a capitalization of excess earnings method is of little value to exempt entities.

By recognizing the presence of going concern value, an exempt entity can increase the purchase price offered over the limitation of the capitalization of excess earnings method. Where a competing bid from a nonexempt entity is present, this method would enable the exempt entity to attempt to match the competing bid. The difficulty, however, is determining what limits should be placed on the amount of going concern value that an exempt entity can purchase without violating the private inurement proscription.

One case that has considered the development of a formula for valuing going concern value, Concord Control, Inc. v. Commissioner, adopted a capitalization formula. The court, however, recognized that two other methods of valuing going concern value may be appropriate: first, the bargain of the parties; and, second, a residual approach. If an exempt entity is forced to use a capitalization formula, the same problems will exist as currently exist for exempt entities bidding against nonexempt entities. If a bargain of the parties or residual approach is used, however, the exempt entity will be able to match an offer from a nonexempt bidder when the purchase price exceeds the limitations of the capitalization of excess earnings method of valuing goodwill.

CONCLUSION

By adopting the residual method in the temporary regulations under section 1060, the IRS has expressly admitted the difficulties associated with valuing goodwill and going concern value. Because of these difficulties, the penalty associated with misvaluing goodwill under the residual method is now relatively small. Exempt entities, however, still face a much greater penalty than nonexempt entities for misvaluing goodwill.

As competition between nonexempt and tax-exempt entities for the acquisition of businesses increases, Congress must equalize the penalty

106. Wiener, supra note 24, at 194-95. The author states: "If going concern value really exists, it theoretically should be present in every acquisition .... The fact that a going enterprise is worth more than an unassembled group of assets is so self-evident as to require no analysis." Id. (emphasis in original).


108. 78 T.C. 742 (1982).

109. Id. at 746-50 (the bargain of the parties method assumes an arms length transaction and the residual method assumes no discrepancies in appraisals of fair market value; these assumptions do not exist with the capitalization method).

110. Id. The bargain of the parties is based on an agreement between parties with adverse legal interests reached as a result of arm's-length bargaining. Id. at 745. The residual method is the same as the method employed by the temporary regulations of section 1060. Id. at 745-46.
for misvaluing goodwill. Failure to do so may unfairly prevent a tax-exempt entity from matching a bid from a nonexempt competitor. Congress has several options available that will permit an exempt entity to pay the same price for goodwill and going concern value as a nonexempt entity. The residual method can be employed in the tax-exempt context, while still protecting against abuses that will result in private inurement. In addition, recognizing the presence of going concern value will provide an additional margin of error for exempt entities. The adoption of one of the suggested methods will enable exempt entities to match competitive offers—offers that reflect the true notion of fair market value.