

Fourth Circuit Upholds Denial of Work Force Depreciation

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Ithaca Industries, Inc., 97 TC No. 16 (1991), involved the largest U.S. private-label manufacturer of women's sheer hosiery and underwear, as well as a major producer of men's and boy's private-label underwear. On the retirement of the founder and majority shareholder, Merrill Lynch formed New Ithaca Industries, which in 1983 bought old Ithaca's stock and liquidated the company.

The stock purchase agreement did not allocate the purchase price among the various assets, and there were reportedly no negotiations over the specific price for items purchased. However, prior to the acquisition, an appraisal of old Ithaca's assets was obtained that included specific allocations to the various assets, including old Ithaca's work force and its raw materials contracts.

Work Force Deductions

Based on the figures obtained from the appraisal, Ithaca assigned an average per capita amount to each of its hourly and production work force and staff employees. The company then claimed amortization deductions for its 1984 and 1985 fiscal years. Predictably, the Service determined that the amounts allocated to these items were merely part of the company's going-concern value, and therefore, were not amortizable.

The Tax Court upheld the Service's determination, noting prior authority, and recognizing that an assembled work force is necessary to operate most businesses without interruption during and after an acquisition. The court further found that the work force was not a wasting asset with a reasonably ascertainable useful life and value. This particular comment seemed to open the door to amortization deductions where the taxpayer *could* show a history of measurable employee turnover within an ascertainable period following an acquisition, something that companies in at least some cases may be able to demonstrate.

Continued on Page 4



Court of Appeals Agrees

Now, a divided Fourth Circuit has affirmed. Citing *Newark Morning Ledger Co. v. U.S.*, 113 S.Ct. 1670 (1993), a majority of the court relied on the existence of Section 197, which allows taxpayers to claim tax benefits from assets with a proven limited useful life, even though the asset may reflect the expectancy of continued patronage. Mass assets, however, are considered nonwasting assets because they remain essentially the same over time, notwithstanding their periodic regeneration. Indeed, this ability to regenerate by itself—with no significant affirmative efforts by the entity—is the hallmark of the mass asset.

In this case, the Fourth Circuit admitted that Ithaca Industries was required to expend significant efforts to regenerate and train its work force, thus making the mass asset theory inapplicable. However, the Fourth Circuit could not get past the problem that there could be no defensible estimation of the duration of any one person's employment, nor of the useful life of the work force of which he or she was a part.

Distinguishing the work force in *Ithaca* from the subscription base in *Newark Morning Ledger*, the Fourth Circuit viewed a subscription as susceptible primarily to the influences of the subscriber only. An employment relationship, on the other hand, has at least two primary parties who may influence the arrangement: the employee and the employer. The court all but foreclosed the possibility that a taxpayer's data could show patterns of attrition, etc., that would be sufficient to avoid the treatment that Ithaca ultimately received. (Interestingly, the Tax Court had not assessed Ithaca's statistical evidence.)

Ray of Hope?

Indeed, the Fourth Circuit found that no statistical methodology could provide a sufficiently trustworthy evidentiary basis for finding both ascertainable value and limited useful life for a work force. It was this seemingly drastic conclusion with which the concurring judge in the Fourth Circuit disagreed. Although the concurring judge agreed with much

of the majority's analysis, he also disagreed with the conclusion that Ithaca's work force had no ascertainable value or ascertainable limited life. ■