Concord Control, Inc. v. Commissioner, 78 T. C. 742 (1982)

The Tax Court established the capitalization of earnings method to calculate going-concern value in business acquisitions when goodwill is absent.

Summary

Concord Control, Inc. acquired K-D Lamp Company in 1964, and the Tax Court determined that no goodwill was transferred, but going-concern value was present. The case was remanded by the Sixth Circuit to explain the calculation method for going-concern value. The Tax Court adopted the capitalization of earnings method, calculating K-D's average annual earnings over five years, appraising tangible assets, and applying an industry-standard rate of return. The difference between actual and expected earnings was then capitalized to determine a going-concern value of $334,985, which was allocated to depreciable assets to determine their basis.

Facts

In February 1964, Concord Control, Inc. purchased K-D Lamp Company from Duplan Corp. The sale was conducted at arm's length but the parties were not tax-adverse. The Tax Court found no goodwill was transferred but identified going-concern value, which is the increase in value of assets due to their existence as part of an ongoing business. The Sixth Circuit affirmed this finding but remanded the case for a clear explanation of how the going-concern value was calculated. K-D manufactured automotive safety equipment and had a precarious market position due to reliance on a single client and competition from several competitors.

Procedural History

The Tax Court initially held in T. C. Memo 1976-301 that no goodwill was acquired by Concord in the purchase of K-D but that going-concern value was present and estimated it. The Sixth Circuit affirmed the existence of going-concern value but remanded for an explanation of the calculation method. On remand, the Tax Court used the capitalization of earnings method to determine the going-concern value was $334,985 and allocated this value to determine the depreciable basis of assets.

Issue(s)

1. Whether the capitalization of earnings method is an appropriate way to calculate going-concern value in the absence of goodwill?

2. How should the going-concern value be allocated to determine the depreciable basis of assets?

Holding

1. Yes, because the capitalization of earnings method provides a systematic approach to valuing the business as a whole, considering its earning potential and the fair return on tangible assets.

2. The going-concern value should be allocated proportionally to the purchase price of each depreciable asset to determine their basis, as this reflects the value of the business as an ongoing entity.

Court's Reasoning

The Tax Court reasoned that since no single method for valuing intangibles is universally accepted, the capitalization of earnings method was appropriate given the facts. This method was chosen because it focuses on the business's total value as an ongoing entity, not just the value of individual assets. The court calculated K-D's average annual earnings over five years to estimate future earning potential and compared this with the expected earnings from tangible assets alone, using industry data to determine a fair rate of return (7. 8%). The difference was attributed to going-concern value and then capitalized at a 20% rate, considering K-D's market position and barriers to entry in its industry. The court emphasized that going-concern value arises from the ability of assets to continue functioning together post-sale. The allocation of this value to depreciable assets was done proportionally based on their purchase price to reflect the fair market value of the assets as part of an ongoing business.

Practical Implications

This decision clarifies the methodology for calculating going-concern value in business acquisitions where goodwill is absent. Legal practitioners should use the capitalization of earnings method when assessing the value of an ongoing business, focusing on the entity's earning potential and the fair return on tangible assets. This case impacts how business valuations are conducted for tax purposes, particularly in asset allocation for depreciation. It also influences how businesses structure acquisitions to account for going-concern value, which could affect negotiations and financial planning. Subsequent cases, such as Forward Communications Corp. v. United States, have applied similar valuation methods, reinforcing the precedent set by Concord Control.

