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Department of the Treasury

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Legend:

Taxpayer =

a =

b =

Year 1 =

Year 2 =

X Division =

Y Division =

Z Division =

Year 3 =

c =

Dear :

This is in reply to your letter of January 11, 2002, and additional correspondence dated March 6, 2002, and June 6, 2002, requesting a ruling on the proper treatment of goodwill and going concern value under §§ 197 and 1221 of the Internal Revenue Code. Specifically, Taxpayer requests a ruling that the goodwill and going concern value sold under the circumstances described below are capital assets within the

meaning of § 1221. The resolution of this issue depends upon whether the goodwill and going concern value at issue are "amortizable section 197 intangibles" or are properties of a character that are subject to the allowance for depreciation provided in § 167.

Taxpayer represents the following facts for purposes of this ruling request. Taxpayer is the parent of an affiliated group of corporations which file a consolidated federal income tax return. Taxpayer uses the calendar year as its taxable year and uses an accrual method of accounting.

Taxpayer and its subsidiaries are currently in the business of providing a services. During Year 1 through Year 2, Taxpayer operated a b business consisting of three separate business divisions–X Division, Y Division, and Z Division. Taxpayer decided in Year 2 to dispose of its X Division and its Y Division, in order to concentrate on its Z Division. The disposition of these two divisions occurred primarily in Year 3, and was fragmented into numerous transactions that involved the sale of stock and assets. As a part of the sale of X Division and Y Division, Taxpayer disposed of approximately twenty c, which are the subject of this letter ruling. Each sale was structured as either an asset sale or a stock sale to which an election under § 338(h)(10) of the Code was made. Thus, for federal income tax purposes, all of the sales are treated as asset sales.

Each sale generated taxable gain for the selling entity. At the time of each sale, the relevant selling entity was a member of an affiliated group headed by Taxpayer, filing a consolidated federal income tax return. In each sale, the residual sale price in excess of fair market value of all other assets was allocated to goodwill and going concern value (hereinafter, this goodwill and going concern value are referred to collectively as the "Goodwill") in accordance with §§ 338 and 1060 of the Code.[1]

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[1] The national office generally issues a letter ruling on a proposed transaction and on a completed transaction if the letter ruling request is submitted before the return is filed for the year in which the transaction that is the subject of the request was completed. Section 5.01 of Rev. Proc. 2002-1, 2002-1 I.R.B. 1,12-13. For the taxable year ended December 31, Year 3, Taxpayer reported gain attributable to the sale of the goodwill and going concern value as ordinary income under § 1231 and reduced the net operating loss carryover of Taxpayer for that year. Taxpayer represents that it is in the process of amending its Year 3 return for issues unrelated to reporting the gain attributable to the sale of goodwill and going concern value, and although this goodwill and going concern value issue is in an earlier return of Taxpayer, none of the circumstances described in section 8.01(4)(a) through (g) or section 5.01(1) of Rev. Proc. 2002-1 apply to Taxpayer. This ruling is issued in reliance on these representations.

Taxpayer represents that at the time of each sale, none of the selling entities were entitled to amortize the Goodwill and the Goodwill represented either self-created Goodwill of the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) or Goodwill acquired by the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) from third parties prior to August 11, 1993. While it is possible that a selling entity acquired the Goodwill after July 25, 1991, and prior to August 11, 1993, no retroactive election was made under § 1.197-1T of the Income Tax Regulations.

LAW AND ANALYSIS

Section 1221(a) provides that the term capital asset means property held by the taxpayer (whether or not connected with the taxpayer's trade or business), but does not include the exclusions specified in §§ 1221(a)(1)-(8). The exclusions from capital asset categorization are (1) stock in trade or other property of a kind which would properly be includible in inventory, or property held by the taxpayer primarily for sale in the ordinary course of business; (2) property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, or real property used in the trade or business; (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by its creators or certain transferees; (4) certain accounts or notes receivable acquired in the ordinary course of a trade or business; (5) certain publications of the United States Government; (6) certain commodities derivative financial instruments held by commodities derivatives dealers; (7) certain hedging transactions; and (8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of business.

Section 197(a) provides that a taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. For purposes of § 197, § 197(c)(1) generally provides that the term "amortizable section 197 intangible" means any section 197 intangible that is acquired by the taxpayer after the date of the enactment of § 197 [August 10, 1993], and that is held in connection with the conduct of a trade or business or an activity described in § 212. Section 197(c)(2)(B) provides that the term "amortizable section 197 intangible" shall not include any section 197 intangible that is not described in § 197(d)(1)(D), (E), or (F), and that is created by the taxpayer.

Section 197(d)(1)(A) and (B) provides that, except as otherwise provided in § 197, the term "section 197 intangible" includes goodwill and going concern value.

Section 197(f)(7) provides that for purposes of chapter 1 of the Code, any amortizable section 197 intangible shall be treated as property that is of a character subject to the allowance for depreciation provided in § 167.

Section 1.197-2(a)(1) provides, in general, that § 197 allows an amortization deduction for the capitalized costs of an amortizable section 197 intangible and prohibits any other depreciation or amortization with respect to that property. Section 1.197-2(b) provides that, except as otherwise provided in § 1.197-2(c), the term "section 197 intangible" means any property described in § 197(d)(1). Section 1.197-2(b)(1) and (2) provide that section 197 intangibles include goodwill and going concern value.

Section 1.197-2(d)(1) provides that except as otherwise provided in § 1.197-2(d), the term "amortizable section 197 intangible" means any section 197 intangible acquired after August 10, 1993 (or after July 25, 1991, if a valid retroactive election under § 1.197-1T has been made), and held in connection with the conduct of a trade or business or an activity described in § 212. Except as provided in § 1.197-2(d)(2)(iii), § 1.197-2(d)(2)(i) generally provides that amortizable section 197 intangibles do not include any section 197 intangible created by the taxpayer (a self-created intangible). Section 1.197-2(d)(2)(iii)(A) provides that the exception for self-created intangibles does not apply to any section 197 intangible described in § 197(d)(1)(D), § 197(d)(1)(E), or § 197(d)(1)(F).

Section 1.197-2(g)(8) provides that an amortizable section 197 intangible is treated as property of a character subject to the allowance for depreciation under section 167. Thus, for example, an amortizable section 197 intangible is not a capital asset for purposes of section 1221, but if used in a trade or business and held for more than one year, gain or loss on its disposition generally qualifies as section 1231 gain or loss.

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business, or of property held for the production of income.

Section 1.167(a)-3 provides that an intangible asset may be the subject of a depreciation allowance if it is known from experience or other factors to be of use in the business or in the production of income for only a limited period of time, the length of which can be estimated with reasonable accuracy. This section further provides that an intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. Section 1.167(a)-3 also provides that no deduction for depreciation is allowable with respect to goodwill.

Also, no deduction for depreciation is allowable for going concern value. See Northern Natural Gas Co. v. United States, 470 F.2d 1107 (8th Cir. 1973), cert. denied, 412 U.S. 939 (1973); see also UFE, Inc. v. Commissioner, 92 T.C. 1314 (1989).

It is well settled that prior to enactment of § 197, goodwill and going concern value were considered to be intangible and nonamortizable capital assets within the

meaning of § 1221, by both the Service and the courts. Rev. Rul. 65-180, 1965-2 C.B. 279; Rev. Rul. 55-79, 1955-1 C.B. 370; UFE, Inc. v. Commissioner, 92 T.C. 1314, 1323 (1989) ("[g]oing-concern value is an intangible, nonamortizable capital asset that is often considered to be part of goodwill"); Patterson v. Commissioner, 810 F.2d 562, 569 (6th Cir. 1987) (stating that "any amount paid for goodwill, since it does not waste, becomes a nonamortizable capital asset," and "amounts received by a seller for the goodwill or going concern value of the business are taxed at the more favorable capital gains rates"); Better Beverages, Inc. v. United States, 619 F.2d 424, 425 n. 2 (5th Cir. 1980) ("goodwill is a capital asset"); Dixie Finance Co. v. United States, 474 F.2d 501, 506 n. 5 (5th Cir. 1973) (goodwill is a capital asset and amounts received therefor in excess of the seller's basis are treated as capital gains, but represent a nonamortizable capital investment resulting in no corresponding deduction for the purchaser); Commissioner v. Killian, 314 F.2d 852, 855 (5th Cir. 1963) ("[i]t is settled that goodwill, as a distinct property right, is a capital asset under the tax laws"); Michaels v. Commissioner, 12 T.C. 17 (1949) ("[w]e entertain no doubt that goodwill and such related items as customers' lists are capital assets").

Prior to enactment of § 197, goodwill and going concern value were not considered property used in the trade or business of a character which is subject to the allowance for depreciation provided in § 167, and thus were not excluded from the definition of capital asset by reason of § 1221(a)(2) of the Code. Under § 197, an amortizable section 197 intangible is treated as property of a character which is subject to the allowance for depreciation under § 167. Thus, goodwill and going concern value which are amortizable section 197 intangibles are not capital assets for purposes of § 1221, but if used in a trade or business and held for more than one year, gain or loss upon their disposition generally qualifies as § 1231 gain or loss. Taxpayer has questioned whether enactment of § 197 has changed the treatment of goodwill and going concern value as capital assets for goodwill and going concern value that do not qualify as amortizable section 197 intangibles.

In this case, Taxpayer represents that at the time of each sale of the c, the Goodwill is either self-created Goodwill of the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) or Goodwill acquired by the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) from third parties prior to August 11, 1993. While it is possible that a selling entity acquired the Goodwill after July 25, 1991, and prior to August 11, 1993, Taxpayer also represents that no retroactive election was made under § 1.197-1T. These representations are material representations. Based solely on Taxpayer's representations with respect to the Goodwill, we conclude that the Goodwill is not an amortizable section 197 intangible, and furthermore is not subject to depreciation under § 167. Thus, the Goodwill is not property that is of a character subject to the allowance for depreciation provided in § 167.

Because we conclude the Goodwill is not an amortizable section 197 intangible and is not property that is of a character subject to the allowance for depreciation provided in § 167, we further conclude that the Goodwill sold by Taxpayer qualifies as a capital asset under § 1221. Although § 197 now provides that goodwill and going concern value that is an amortizable section 197 intangible are not capital assets for purposes of § 1221, it does not address the treatment of goodwill and going concern value that is not an amortizable section 197 intangible, nor does it change prior law treatment of goodwill and going concern value.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express no opinion regarding the basis of the Goodwill. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the provisions of a power of attorney on file with this office, we are sending a copy of this letter ruling to Taxpayer's authorized representatives.

Sincerely,

DOUGLAS A. FAHEY
Assistant to the Chief, Branch 3
Office of Associate Chief Counsel
(Income Tax and Accounting)

cc: