

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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subject: Deductibility of Purportedly Worthless Goodwill

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Dealer =  
Manufacturer =  
W =  
X =  
Y1 =  
Y2 =  
Z =  
Date1 =  
Date2 =  
Date3 =

\$39x            =

\$4x             =

## ISSUE

Manufacturer terminated Dealer's franchise rights to sell W and Y2 automobiles, and Dealer argues the goodwill allocated to those franchises became worthless. May Dealer deduct, as purportedly worthlessness, the goodwill associated with those franchises?

## CONCLUSIONS

Even if the goodwill associated with the W and Y2 franchises became worthless when Manufacturer terminated the franchise agreements, section 197(f)(1) of the Internal Revenue Code<sup>1</sup> prohibits a deduction for worthless amortizable section 197 intangibles, including goodwill, where other amortizable section 197 intangibles purchased as part of the same transaction or series of transactions remain. The amount of any worthless amortizable section 197 intangibles instead is included in the basis of the remaining amortizable section 197 intangibles.

## FACTS

Dealer sells and services Manufacturer's products pursuant to franchise agreements. On Date1, Dealer purchased certain assets of another auto dealer; this sale included \$39x for goodwill related to franchise rights to sell (including parts) and service W, X, Y1, Y2, and Z automobiles. Although Dealer claims that \$4x of goodwill was allocated to the W franchise purchase, we see nothing in the contract that makes any such allocation. The information provided to you by Dealer is an unsigned, undated summary. We cannot tell who prepared this summary, when it was prepared, or for what purpose.

On Date2, Dealer received notice that Manufacturer was terminating its franchise to sell W products. Later, on Date3, Dealer also received notice that Manufacturer was terminating its Y2 franchise. In consideration for these franchise terminations and Dealer's covenants, releases, waivers, and transfer to Manufacturer of a non-exclusive right to use Dealer's customer lists and service records, Dealer received from Manufacturer payment of approximately 1.8% of \$39x.<sup>2</sup> Dealer therefore claims that the goodwill associated with its terminated W and Y2 franchises became worthless on Date2 and Date 3, respectively.

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<sup>1</sup> Unless otherwise noted, references to "section" refer to the Internal Revenue Code of 1986, as amended.

<sup>2</sup> The tax treatment of the amounts Dealer received as consideration for the W and Y2 franchise terminations is not in dispute in this case. See, e.g., Rev. Rul. 2007-37, 2007-1 C.B. 1390.

## LAW AND ANALYSIS

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. The amount of any such deduction is subject to any provision of the Code that prohibits it or limits the amount. Treas. Reg. § 1.165-1(a).

Section 197(a) allows a taxpayer to amortize an “amortizable section 197 intangible” ratably over a 15-year period. If an asset is an “amortizable section 197 intangible,” it is amortizable over a 15-year period, even if the asset might have a different useful life. I.R.C. § 197(b). See, e.g., *Frontier Chevrolet Co. v. Commissioner*, 329 F.3d 1131, 1135 (9th Cir. 2003) (noting that the enactment of section 197 in 1993 to govern the amortization of intangibles superseded older rules about amortizing an intangible over its life).

An “amortizable section 197 intangible” means any “section 197 intangible” that is acquired by the taxpayer after August 11, 1993 and is held in connection with the conduct of a trade or business or an activity described in section 212. I.R.C. § 197(c)(1). Certain self-created intangibles are excluded from the definition of “amortizable section 197 intangible.” I.R.C. § 197(c)(2).

A “section 197 intangible” includes goodwill and any franchise, trademark, or trade name. I.R.C. § 197(d)(1)(A), (F). For purposes of section 197(d)(1)(F), the term “franchise” has the same meaning as in section 1253(b)(1). I.R.C. § 197(f)(4); Treas. Reg. § 1.197-2(b)(10). Under section 1253(b)(1), a franchise includes an agreement that gives one of the parties the right to distribute, sell, or provide goods, services, or facilities within a specified area.

Section 197(f)(1) states that, if there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained, then (i) no loss may be recognized, and (ii) appropriate basis adjustments must be made to the retained intangibles. See Treas. Reg. § 1.197-2(g)(1). The abandonment of an amortizable section 197 intangible, or any other event rendering an amortizable section 197 intangible worthless, is treated as a disposition of the intangible for purposes of section 197(f)(1) and Treas. Reg. § 1.197-2(g)(1). Treas. Reg. § 1.197-2(g)(1)(i)(B).

Dealer’s situation falls within section 197(f)(1). Dealer acquired the franchises and goodwill after the enactment of section 197, so the goodwill is an amortizable section 197 intangible.<sup>3</sup> Dealer does not dispute this fact. However, Dealer claims that the goodwill associated with the W and Y2 franchises became worthless. But, under section 197(f)(1), the taxpayer cannot deduct any such loss. Instead, Dealer must

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<sup>3</sup> In a case where a dealer acquired the franchise after January 1, 1970 but before the effective date of section 197, it appears that I.R.C. § 1253 would govern the tax treatment of this type of situation. (Section 1253 was effective January 1, 1970.)

make appropriate adjustments to the basis of the retained amortizable section 197 intangibles.

Dealer makes two principal arguments in support of deducting the goodwill associated with the W and Y2 franchises. First, Dealer claims that the asset purchase agreement separately stated a goodwill value for the W franchise. Dealer reasons that the remainder of the goodwill was, therefore, allocable to the X, Y1, Y2, and Z franchises. We have reviewed the purchase agreement and find no such allocation. The allocation that Dealer provided to you was on a summary sheet that is undated and unsigned. There is no evidence that this summary was ever included in the original agreement. And even if the goodwill was separately stated for each franchise, we believe section 197(f)(1) still applies, as all of the goodwill was acquired in a single transaction or series of related transactions. Dealer even admits that Manufacturer required alignment of certain franchises and considered multiple franchises as one “unit” for franchising purposes.

Next, Dealer argues that section 197(f)(1) does not apply to its special situation and that the “spirit” of section 197(f)(1)(A)(i) did not contemplate automobile franchises. We find no support for this argument. Section 197 clearly defines the intangibles to which it applies and allows limited exceptions. The goodwill that Dealer wishes to deduct as worthless is included in the definition of “amortizable section 197 intangible” and is not excluded by any exception. There is no indication in the Code or section 197’s legislative history that Congress intended to exempt automobile franchises from section 197(f)(1).

## SUMMARY

Because the goodwill that Dealer wants to deduct as worthless is an amortizable section 197 intangible and Dealer retains other amortizable section 197 intangibles that were acquired in the same transaction or series of related transactions as the worthless goodwill, section 197(f)(1) prohibits any deduction for worthlessness in this case. Instead, Dealer must adjust the basis of its remaining goodwill.

Please call \_\_\_\_\_ if you have any further questions.

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