Office of Chief Counsel
Internal Revenue Service

memorandum

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date: March 6, 2001

to: Examination Division
Attn: Todd Szweda, Engineer, LMSB Team 1865

from: Area Counsel, Milwaukee

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subject: [redacted]
Trade Name and Covenant Not to Compete

On October 11, 2000, we received a memorandum from you in which you ask various questions regarding [redacted] acquisition of the trade name "[redacted]" and a covenant not to compete signed by [redacted], former chairman of the [redacted]. Our advice is given below.

Facts

On [redacted], the owners of the [redacted] entered into an agreement (hereinafter "the purchase agreement") to sell all of their interest in that company to [redacted] (hereinafter "the taxpayer"). In accordance with the purchase agreement, on [redacted], the taxpayer acquired all the shares of [redacted] for approximately $[redacted]. As of [redacted], [redacted] ceased to have a separate corporate existence and became a division of the taxpayer.

Upon acquiring the [redacted], the taxpayer segregated out two intangible assets. The first asset was a covenant by [redacted] (the chairman of [redacted]) not to compete with the taxpayer for a period of [redacted] years after he left the taxpayer's employment. The second asset was the trade name "[redacted]." Neither of these items had been specifically bargained for or separately evaluated in the purchase agreement, but were apparently included in the $[redacted] purchase price.

On its books, the taxpayer originally placed a value of $[redacted] on the trade name and $[redacted] on the covenant not to compete, for a total of $[redacted]. After receiving an appraisal from [redacted], the taxpayer adjusted its books to indicate an original value of $[redacted] for the trade name and $[redacted] for the noncompete agreement, for a total of $[redacted]. The remaining $[redacted] ($[redacted] minus $[redacted]) was reallocated to the basis in the stock. The taxpayer began to amortize the two assets on [redacted] year schedules.

Prior to the taxpayer's purchase of [redacted], [redacted] had been receiving the following amounts per year from [redacted] in salary, bonus, and incentives:

[redacted]	$[redacted]
	$
	$

At about the same time that the purchase agreement was executed, [redacted] entered into an "executive employment contract" with the taxpayer for the [redacted]-year period from [redacted] to [redacted]. His compensation under this contract was rather complicated, but included a base salary of $[redacted] and guaranteed annual bonuses between $[redacted] and $[redacted]. As part of this employment contract, he also agreed "for a period of [redacted] years after the termination of active employment hereunder" not to "engage in, be employed by, or in any way advise or act for, or have any financial interest in any business which is a competitor of the [taxpayer]."

The purchase agreement specified that, upon the written request of the sellers, the taxpayer must cease to use the trade name "[redacted]" or any name similar to it, and that the sellers had the right to exercise this right unilaterally at their discretion at any time. One of the sellers, [redacted] (and her successors), retained the right to have the trade name removed from the taxpayer and assigned to her "at her sole discretion." The agreement also provided that the taxpayer had no right to sell or assign the trade name to any third parties, except with the consent of the sellers. The taxpayer has stated in writing that, as a result of these restrictions, the taxpayer had only a "contingent right" to use the trade name.

In [redacted] (approximately [redacted] years after the purchase), the taxpayer changed the name of its [redacted] Division to [redacted] and ceased to use the [redacted] trade name. [redacted]. According to the taxpayer, the [redacted] name was "considered quite valuable" at the time the taxpayer ceased to use it. Upon ceasing to use the name, the taxpayer immediately wrote off the entire remaining basis in the trade name (approximately $[redacted]). It claimed a deduction in this amount on its [redacted] return on the grounds that the trade name had been lost or abandoned.

Upon review of the tax returns, it does not appear that the taxpayer made a Section 338 election to treat the [redacted] stock acquisition as an asset acquisition under Section 1060.

Issues

(1) Can the taxpayer establish the trade name and the covenant not to compete as separate assets on its books, subject to I.R.C. § 197 amortization, despite the fact that the taxpayer's acquisition of the [redacted]'s stock was not a Section 338 acquisition?

(2) Can the taxpayer claim depreciation and abandonment deductions for the trade name despite the substantial rights in the name retained by the sellers? If the taxpayer can claim an abandonment loss, can the remaining basis be claimed as a deduction in a single year or should it be reallocated to the covenant not to compete?

(3) Is the covenant not to compete within the coverage of I.R.C. § 197 so that the taxpayer can claim depreciation deductions?

Law

I.R.C. § 165 allows deductions for "any loss sustained during the taxable year and not compensated for by insurance or otherwise."

I.R.C. § 167 allows "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . of property used in the trade or business."

I.R.C. § 197 applies to intangible assets acquired by businesses after August 10, 1993. It states:

> (a) A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis of such

intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

I.R.C. § 197(d)(1) defines "section 197 intangible" to include:

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and
(F) any franchise, trademark, or trade name.

I.R.C. § 197(e)(1) provides that "the term 'section 197 intangible' shall not include . . . any interest in a corporation."

Treas. Reg. § 1.197-2(a)(1) states:

Section 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. Paragraphs (b) (c), and (e) of this section provide rules and definitions for determining whether property is a section 197 intangible . . .

Treas. Reg. § 1.197-2(b) states:

Except as otherwise provided in paragraph (c) of this section, the term "section 197 intangible" means any property described in [I.R.C.] section 197(d)(1). The following rules and definitions [subparagraphs (b)(1) through (b)(12)] provide guidance concerning property that is a section 197 intangible unless an exception applies.

Treas. Reg. § 1.197-2(b)(9) states:

Section 197 intangibles include any covenant not to compete, or agreement having substantially the same effect, entered into in connection with the direct or indirect acquisition of an interest in a trade or business or a substantial portion thereof . . . For purposes of this paragraph (b)(9), an acquisition may be made in the form of an asset acquisition (including a qualified stock purchase that is treated as a

> purchase of assets under section 338), a stock acquisition or redemption, and the acquisition or redemption of a partnership interest. An agreement requiring the performance of services for the acquiring taxpayer . . . does not have substantially the same effect as a covenant not to compete to the extent that the amount paid under the agreement represents reasonable compensation for the services actually rendered . . .

Treas. Reg. § 1.197-2(b)(10) states:

> Section 197 intangibles include any franchise, trademark, or trade name. . . . The term trade name includes any name used to identify or designate a particular trade or business or the name or title used by a person or organization engaged in a trade or business.

Treas. Reg. § 1.197-2(g)(1)(i)(A) and (B) state:

> (A) No loss is recognized on the disposition of an amortizable section 197 intangible if the taxpayer has any retained intangibles. The retained intangibles with respect to the disposition of any amortizable section 197 intangible (the transferred intangible) are all amortizable section 197 intangibles, or rights to use or interests (including beneficial or other indirect interests) in amortizable section 197 intangibles (including the transferred intangible) that were acquired in the same transaction or series of related transactions as the transferred intangible and are retained after its disposition.
>
> (B) 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 this paragraph (g)(1) . . .

I.R.C. § 338 provides that a corporation (the purchasing corporation) that acquires the stock of another corporation (the target or acquired corporation) may elect to have the purchase in effect treated as a purchase of the target's assets. Under I.R.C. § 338(b), this usually results in the step-up of the basis of the acquired corporation's assets.

Under I.R.C. § 338(g)(2) and Treas. Reg. § 1.338-2T(d), election to apply § 338 is made by filing a Form 8023 not later than the fifteenth day of the ninth month beginning after the month in which the acquisition occurs.

Analysis

Issue (1): Interaction of I.R.C. §§ 197 and 338

You argued in your memorandum that the trade name "[redacted]" cannot be considered as a separate amortizable asset in the hands of the taxpayer because the taxpayer acquired the [redacted] as a stock purchase and did not elect Section 338 treatment. We agree.

I.R.C. § 197 provides clear and uniform rules for the amortization of specified intangible assets, including trade names and covenants not to compete. Section 197(e)(1), however, provides that "any interest in a corporation" (e.g. stock) is not a Section 197 intangible. In the present case, the taxpayer purchased all the stock of the [redacted]. The taxpayer did not purchase the trade name separately, nor was the trade name carried on the books of [redacted] as a separate asset. Under § 197(e)(1), none of the purchase price of the stock-- absent a § 338 election-- is amortizable under § 197. Accordingly, the taxpayer has no basis in the trade name "[redacted]" to be recovered through amortization or deducted for abandonment.

Under I.R.C. § 197(d)(1)(F), the definition of amortizable asset explicitly includes any trade name. This rule is repeated in Treas. Reg. § 1.197-2(b). Treas. Reg. § 1.197-2(b)(10) begins with the rule "Section 197 intangibles include any franchise, trademark, or trade name," without reference to any explicit modifications. Although these rules seem broad, they all presuppose that the trade name is an asset of the taxpayer, legitimately carried as a separate asset on the taxpayer's books. As explained above, however, that is not the case here. Section 197 therefore has no application.

Unlike the trade name, the covenant not to compete is a separate asset on the taxpayer's books within the meaning of I.R.C. § 197, regardless of Section 338. Section 197 amortization applies to covenants not to compete even if acquired as part of a stock purchase. This is because § 197(d)(1)(E) explicitly states that "any covenant not to compete . . . entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business is a Section 197 intangible."

Issue (2): Depreciation and Abandonment of the Trade Name

The taxpayer cannot claim depreciation or abandonment deductions arising from the trade name "[redacted]" primarily because the taxpayer did not own a separate interest in that name under I.R.C. §§ 197 and 338, as explained above. A secondary reason for denying depreciation and abandonment deductions is that the taxpayer did not have a "depreciable interest" under traditional tax and accounting principles.

Depreciation of property is not predicated upon "ownership" of property, but rather upon an "investment" in property. No investment exists, however, when the purchaser acquires no equity. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). A taxpayer with bare legal title to property, but no capital investment or economic interest in it, cannot claim depreciation. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). Title is not determinative; a buyer will not be entitled to depreciation deductions if the seller retains most of the benefits and burdens of ownership. Bailey v. Commissioner, 912 F.2d 44 (2d Cir. 1990). In cases where a buyer does not obtain full ownership, however, he may depreciate whatever interest he does acquire. Bailey v. Commissioner, 912 F.2d 44 (2d Cir. 1990). The taxpayer is entitled to depreciation deductions if he is the person who suffers the economic loss of his investment by virtue of the wear and tear or exhaustion of the property, i.e. if he is the person who has the economic benefits and burdens of ownership. Frank Lyon Company v. United States, 435 U.S. 561 (1978). In making these determinations, substance rules over form.

In the present case (even if we overlook the Sections 197 and 338 issue), the taxpayer's interest in the trade name "[redacted]" was very limited and tenuous. Under the purchase agreement, the taxpayer technically owned the trade name. The taxpayer's ownership and use of the name, however, continued only until such time as the seller decided to take it back. The seller had the right to do so at any time, for any reason, or for no reason. The taxpayer could transfer the trade name to a third party only with the seller's permission. Under these circumstances, it is arguable that the taxpayer had no real interest in the trade name at all. As the taxpayer had no "equity" or "investment" in the name, it could not serve as the basis for any depreciation deductions under I.R.C. § 197, or for abandonment deductions. Even if the taxpayer owned some definable depreciable interest in the trade name, that interest must have had a very low value. In this case it appears that the $[redacted] valuation of the trade name was the estimated value <u>for full ownership and use of the name for its entire useful life</u>. As it is clear that the taxpayer obtained far less than full, unrestricted ownership and use, that valuation is clearly not applicable. The $[redacted] valuation (even if true for the full value of the name) must be very heavily discounted to reflect that the taxpayer had little (if any) "depreciable interest," "equity," or "investment" in the name.

Even if one concedes that the trade name was a separate asset in the hands of the taxpayer (despite the absence of a Section 338 election), that the taxpayer had some small depreciable interest in the trade name (despite the ample rights retained by the sellers), and that it was abandoned or became worthless in [redacted], an abandonment deduction is not appropriate. The tax treatment in case of abandonment is specified in Treas. Reg. § 1.197-2(g)(1). Under that section, if a Section 197 intangible asset acquired in the same transaction as one or more other Section 197 assets becomes worthless, no loss is recognized on the worthlessness and the adjusted basis of the retained Section 197 intangibles are increased by the non-recognized loss. In the present case, the covenant not to compete and the trade name (if the trade name is a separate, depreciable asset) are both Section 197 intangibles acquired in the same transaction. Upon abandonment of the trade name, the remaining basis in that asset would be reassigned to the basis in the covenant, not claimed as an immediate deduction.

In a memorandum dated [redacted], the taxpayer conceded that the remaining unamortized purchase price of the trade name at the time of its abandonment should have been reallocated to the noncompete agreement rather than deducted entirely in [redacted].

<u>Issue (3)</u>: <u>Depreciation of the Covenant Not to Compete</u>

As discussed above, the absence of a Section 338 election does not prevent the amortization of the covenant not to compete under Section 197. We do not believe that the covenant can be depreciated in this case, however, because it does not appear to have any recoverable basis.

The covenant is a clause in [redacted]'s employment contract with the taxpayer. There is no mention of the covenant in the purchase agreement. A premise of § 197 coverage is that a covenant not to compete be "entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business." There is nothing in the file that specifically indicates that the covenant in this case was executed "in connection with" the taxpayer's acquisition of [redacted]. A broad reading of the situation, however, may suggest that [redacted]'s employment contract (and thus the covenant) and the purchase agreement were both part of a larger agreement based on the same negotiations. In that event, the covenant would be a Section 197 asset.

The amortization of a covenant not to compete under Section 197, however, depends on the amount paid for the asset. The taxpayer unilaterally put a value of $[redacted] on the covenant. The taxpayer did not pay or promise [redacted] $[redacted] (or any other specific amount) in return for the covenant. The taxpayer's valuation of the covenant is irrelevant to recovery under Section 197. It is what the taxpayer <u>paid</u> for the covenant that is recoverable under Section 197. In this instance, the taxpayer did not pay anything for the covenant and, accordingly, there is no basis subject to amortization.

<u>Conclusions</u>

1. The depreciation deductions for the trade name should be completely disallowed on the grounds that: (a) The taxpayer cannot carry the trade name as a separate asset on its books (and therefore cannot depreciate it) because the taxpayer acquired the trade name as part of a stock acquisition without a Section 338 election; (b) Because of the rights to the name retained by the sellers, the taxpayer did not have a depreciable interest in the trade name under traditional accounting principles; and (c) Even if the taxpayer had a depreciable interest in the trade name, the value of that interest was far less than the amount claimed.

The abandonment deduction for the trade name should be completely disallowed on the grounds that: (a) As the taxpayer had no separate, depreciable interest in the trade name (for the reasons given in the previous paragraph), a deduction for abandonment is as inappropriate as a deduction for depreciation; and (b) Even if the taxpayer did abandon a depreciable interest in [redacted], the remaining basis should have been transferred to the covenant not to compete rather than taken as an immediate deduction.

2. The depreciation deductions for the covenant not to compete should be disallowed on the grounds that, even if the covenant is within the coverage of I.R.C. § 197, the covenant has a basis of zero.

Of course, this advice depends heavily on the facts which you have presented and we caution you not to apply this advice to other taxpayers. If you have any questions or need further advice, please contact J. Paul Knap at 414-297-4246.

STEVEN R. GUEST
Associate Area Counsel

By: ______________________
J. PAUL KNAP
Attorney