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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR CENTRAL CALIFORNIA DISTRICT COUNSEL

FROM: Associate Chief Counsel (Passthroughs & Special Industries)
CC:PSI

SUBJECT: Amortization of Intangibles

This Field Service Advice responds to your memorandum dated July 19, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND:

A	=
B	=
T	=
\$ <u>a</u>	= \$
\$ <u>b</u>	= \$
\$ <u>c</u>	= \$
\$ <u>d</u>	= \$
Year 1	=
Year 2	=
Year 3	=

ISSUE:

Whether payments made by a corporation to former shareholders pursuant to an agreement for the sale of goodwill and a covenant not to compete may be deducted by the corporation as wages and consulting expenses.

CONCLUSION:

To the extent the payments are for wages, they may be currently deducted by the corporation. To the extent the payments are for goodwill or a covenant not to compete, the payments must be amortized under section 197.

FACTS:

A, married individuals, began operating a cardroom and entertainment business as a partnership. Eventually, A incorporated the business, operating a restaurant and cardroom business through T, a wholly owned corporation. In Year 1, the building in which T operated its business was demolished and T's business operations ceased.

In Year 1, a group of investors purchased 90 percent of the stock in T. In Year 2, T opened a restaurant, bar, and deli. In order to continue with the cardroom business, however, T was required to obtain a gaming license. Because of difficulties encountered in obtaining the license, many investors eventually sold their stock in T.

By Year 3, B owned 90 percent of T. On February 28, Year 3, A agreed to sell their 10 percent stock ownership in T to B for \$a. Subsequent to the sale, B would own 100 percent of the stock in T. The sale of the stock was to occur when T opened

for business to the general public as a licensed gaming or cardroom business. Also on February 28, Year 3, A and T entered into an agreement entitled “Agreement of Sale of Goodwill and Covenant Not to Compete” (Agreement). Pursuant to the Agreement, T acquired A’s goodwill and A entered into a covenant not to compete in connection with the sale of goodwill in exchange for a payment of \$b per month. The Agreement would become effective when T acquired all gaming or cardroom licenses necessary to open the business and actually opened for business as a gaming establishment. The payments would continue until the earliest of the death of both As, A’s purchase of T stock which A had a conditional right to repurchase, or A’s violation of the noncompetition agreement.

In Year 3, to ensure the continued patronage of customers of T, A and T orally agreed that A would greet players in the game rooms. In each of October, November, and December of Year 3, T paid A \$b. From each payment, \$c was characterized as “wages” and \$d was characterized as “consulting expense.” T deducted the \$b payment, and A reported it as ordinary income.

LAW AND ANALYSIS

Based on the facts provided, it appears that, subsequent to entering into the Agreement, T and A entered into an oral agreement which modified the Agreement. Under the oral modification, T would pay A \$c per month to greet players in the game room, and the amount paid under the Agreement would be reduced by \$c. To the extent a payment of \$c was reasonable for the service provided, the payment is deductible by T. I.R.C. §§ 61(a)(1); 162(a). See also Treas. Reg. § 1.197-2(b)(9). We recommend that you confirm both T and A agree that the payment of \$c represented a modification of the original Agreement and that it was paid by T for A’s services. To the extent it does not represent a modification or payment for services, the payment of \$c would be included as an amount paid under the Agreement and treated as discussed below.

A taxpayer is entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of the deduction is determined by amortizing the adjusted basis of the intangible over the 15-year period beginning with the month in which the intangible was acquired. I.R.C. § 197(a). No other depreciation or amortization deduction is allowable with respect to any amortizable section 197 intangible. I.R.C. § 197(b).

A “section 197 intangible” includes goodwill and any covenant not to compete entered into in connection with an acquisition, directly or indirectly, of an interest in

a trade or business. I.R.C. §§ 197(d)(1)(A), (E); Treas. Reg. §§ 1.197-2(b)(1), (b)(9). An acquisition may be in the form of a stock acquisition. Treas. Reg. § 1.197-2(b)(9). Under the stock purchase agreement and the Agreement, the covenant not to compete was entered into in connection with B's purchase of A's stock. Accordingly, the goodwill and covenant not to compete are section 197 intangibles.

An "amortizable section 197 intangible" is any section 197 intangible that was acquired by the taxpayer after August 10, 1993, and held in connection with the conduct of a trade or business or an activity described in section 212. I.R.C. § 197(c)(1). The goodwill and covenant not to compete were acquired by T after August 10, 1993, and are held by T in connection with its trade or business.

An "amortizable section 197 intangible" does not include goodwill which was created by the taxpayer. I.R.C. § 197(c)(2); Treas. Reg. §§ 1.197-2(d)(2)(i), (iii). A section 197 intangible is created by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs for its creation, production, development, or improvement, whether the actual work is performed by the taxpayer or by another person under a contract with the taxpayer entered into before the contracted creation, production, development, or improvement occurs. Treas. Reg. § 1.197-2(d)(2)(ii)(A). There is no indication that the goodwill purchased from A was created by T.

Under anti-churning rules set forth in section 197(f)(9), an amortizable section 197 intangible asset does not include, among other things, goodwill which is acquired by the taxpayer after August 10, 1993, if the goodwill was held or used at any time on or after July 25, 1991, and on or before August 10, 1993, by the taxpayer or a related person. I.R.C. § 197(f)(9)(A)(i). A person is related to any person if the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1) wherein "20 percent" is substituted for "50 percent." I.R.C. § 197(f)(9)(C)(i). Because A owned only 10 percent of the stock in A in Year 3, the anti-churning rules are not applicable.

Because the amounts paid pursuant to the Agreement were paid with respect to amortizable section 197 intangibles, T is entitled to begin amortization of amounts properly capitalized when the Agreement became effective.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Because both the amount paid for goodwill and the amount paid for the covenant not to compete are amortizable under section 197, an allocation of T's payment between the two is not necessary. In addition, arguably, there can be no sale of goodwill unless the key employee of the business enters into a covenant not to compete with the corporation. See, generally, Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998); Norwalk v. Commissioner, T.C. Memo. 1998-279.

Please call if you have any further questions.

By: _____
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