OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL

FROM: ASSISTANT CHIEF COUNSEL(FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated April 15, 1999. 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.

LEGEND:

A:
B:
C:
D:
Date 1:
Date 2:
Date 3:
Date 4:
Date 5:
Date 6:
Date 7:
#1:
$A:
$B:
$C:

$D:
$E:

ISSUE(S):

1. Does the Closing Agreement between A and the Service bind A to a determination that its Dealer Relationship Intangible was not of a character subject to the allowance for depreciation?

2. What factual development is needed to determine if the Dealer Relationship Intangible is of a character subject to the allowance for depreciation under pre-197 law?

CONCLUSION:

1. Yes, the Closing Agreement clearly indicates that the parties agreed that the Dealer Relationship Intangible was not of a character subject to the allowance for depreciation.

2. To determine the character of the Dealer Relationship Intangible, you must look at C's records on turnover in its dealer network for several years prior to the sale to B, because the ascertainable life must be determined as of the close of the first year B could have first taken depreciation.

FACTS:

B was a wholly-owned subsidiary of A. On Date 1, B purchased certain assets from C, which included a customer-based intangible ("Dealer Relationship Intangible") consisting of #1 dealers who had previously entered into written dealer sales and service agreements with C.

In Date 2, B was included in the consolidated federal corporate income tax return filed by A. As a result of an examination of A's Date 2 return, a Closing Agreement between the Service and A was struck and signed by the parties in Date 4. This Closing Agreement provided in pertinent part:

> WHEREAS, a dispute has arisen between the parties hereto as to . . . (iii) whether, when and to what extent the Taxpayer's unadjusted tax basis in each of the Acquired Assets may be depreciated, amortized or otherwise deducted or recovered for federal income tax purposes . . .

WHEREAS, a dispute has arisen between the parties hereto as to . . . whether, when and to what extent the C Acquisition Expenditures are capitalizable, and (iii) whether, when and to what extent the C Acquisition Expenditures that are capitalizable may be depreciated, amortized or otherwise deducted or recovered for federal income tax purposes . . .

WHEREAS, the parties hereto desire to resolve with finality the Tax Consideration Issues and the C Acquisition Expenditures Issues;

NOW IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes, as follows:

Tax Consideration Issues . . .

3. Deductions for depreciation and/or amortization under Section 167 and/or Section 168 for the Original Unadjusted Tax Basis of the Acquired Assets identified on Exhibit 3 attached hereto and incorporated herein by reference for all purposes are allowed the Taxpayer as set forth on such Exhibit 3. The depreciable and/or amortizable basis, the date placed in service, the useful life (in years), and the depreciation and/or amortization method for each of such Acquired Assets is as set forth on such Exhibit 3.

C Acquisition Expenditures Issues . . .

5. US $A of the C Acquisition Expenditures are allowed the Taxpayer as ordinary deductions under Section 162, and the taxable years in which the Taxpayer is entitled to such deductions are as set forth on Exhibit 5 attached hereto and incorporated herein by reference for all purposes.

6. The remaining US $B of the C Acquisition Expenditures are capital expenditures and are allocable to certain of the Acquired Assets. The allocation of such amount to such Acquired Assets is as set forth on Exhibit 6 attached hereto and incorporated herein by reference for all purposes. . .

7. To the extent the Taxpayer is allowed deductions for depreciation and/or amortization under Section 167 and/or Section 168 for the Original Unadjusted Tax Basis of an Acquired Asset under the provisions of Section 3 hereof, the Taxpayer is also allowed deductions for depreciation and/or amortization under Section 167 and/or Section 168 for any Additional Unadjusted Tax Basis added to such Acquired Asset under the provisions of Section 6 hereof. With respect to the Additional Unadjusted Tax Basis added to such Acquired Assets, however, the depreciable and/or amortizable basis, the date placed in service, the useful life (in years), the depreciation and/or amortization method, the amount of the deductions for depreciation and/or amortization under Section 167 and/or Section 168, and the taxable years in which the Taxpayer is allowed such deductions are as set forth on Exhibit 6 attached hereto and incorporated herein by reference for all purposes.

Dealer Relationships

8. The aggregate amount of the Original Unadjusted Tax Basis and the Additional Unadjusted Tax Basis allocated to the Acquired Asset identified as "Dealer Relationships" on Exhibits 2 and 6 attached hereto is US$C . . . . The Taxpayer will be entitled to deduct such aggregate amount allocated to the Acquired Asset identified as "Dealer Relationships" on Exhibits 2 and 6 attached hereto upon such time as the last C Dealer has ceased the business of selling and servicing the Taxpayer's new agricultural equipment. . . .

This agreement is final and conclusive except:

(1) the matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of material fact;

(2) it is subject to the Internal Revenue Code sections that expressly provide that effect be given to their provisions (including any stated exception for Code Section 7122) notwithstanding any other law or rule of law; and

> (3) if it relates to a tax period ending after the date of this agreement, it is subject to any law, enacted after the agreemnt date, that applies to that tax period.
>
> By signing, the parties certify that they have read and agreed to the terms of this document.

Exhibit 2 provides that the Dealer Relationships have an original unadjusted tax basis of $D. Exhibit 3 lists the intangible assets that the parties have agreed are depreciable or amortizable. Exhibit 3 does not include the Dealer Relationship Intangible among its list of depreciable assets. Exhibit 5 lists the taxable years in which the taxpayer is entitled to ordinary deductions under section 162 with respect to the C acquisition expenditures and the amounts of such deductions. Exhibit 6 itemizes the "Allocation of the Additional Unadjusted Tax Basis Among Certain of the Acquired Assets and Depreciation and/or Amortization Deductions With Respect to the Additional Unadjusted Tax Basis Allocated to Such Acquired Assets". Dealer Relationships is listed, but unlike other assets, it shows no useful life, no depreciation and/or amortization method and no deductions for depreciation and/or amortization.

In Date 3, A formed a new corporation known as D. As part of a plan to make an initial public offering of stock for D, A reorganized B and its related subsidiaries into one business and transferred the business and assets of B into D. The Dealer Relationship Intangible was included in the assets sold to D as part of this reorganization. B and D did not allocate any of the purchase price to this asset. B claimed an ordinary loss in the amount of $E on A's consolidated return. The Commissioner determined that, pursuant to the Closing Agreement, this amount should be reported as a capital loss. As of this date, this case is in nondocketed status.

LAW AND ANALYSIS

Effect of Closing Agreement

Under Internal Revenue Code Section 1221(2) an asset is not a capital asset if it is property used in a trade or business which is subject to the allowance for depreciation. If an asset is a capital asset, then a loss taken with respect to that asset is a capital loss. Therefore, the crux of the issue is whether the Closing Agreement reflects an agreement by the parties that the Dealer Relationship Intangible was not subject to the allowance for depreciation. An agreement that the Dealer Relationship Intangible was not depreciable would mean that it is a capital asset and any loss taken with respect to that asset should be a capital loss. Both parties agree that the Closing Agreement is binding. Yet the parties disagree as to the proper interpretation of the document. District Counsel contends that the

Closing Agreement clearly reflects that the Dealer Relationship Intangible was not subject to the allowance for depreciation. The taxpayer asserts that there is no explicit statement in the document expressing that the Dealer Relationship Intangible is nondepreciable, therefore the Closing Agreement does not address the issue and is not binding on that topic. If the Closing Agreement is not binding on that topic, then it must still be determined whether the Dealer Relationship Intangible is subject to the allowance for depreciation and thus whether losses taken with respect to the asset are ordinary.

Internal Revenue Code Section 7121(b)"Closing Agreements" provides:

> FINALITY. –If such agreement is approved by the Secretary . . . such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact –
>
> (1) the case shall not be reopened as to the matters agreed upon or the agreement modified by any officer, employer, or agent of the United States, and
>
> (2) in any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside or disregarded.

Courts have unanimously held that closing agreements are meant to determine finally and conclusively a taxpayer's liability for a particular tax year. Hopkins v. United States, 146 F.3d 729, 732-33 (9th Cir. 1998). Yet, a closing agreement is subject to the ordinary principles of contract law and interpretation. See Rink v. Commissioner, 100 T.C. 319 (1993). Courts enforce the plain meaning of the agreement as drawn from its entirety. Silverman v. Commissioner, 105 T.C. 157, 166 (1995).

The Closing Agreement preamble applies to "a dispute . . . between the parties . . . as to whether, when and to what extent the taxpayer's unadjusted tax basis in each of the Acquired Assets may be depreciated, amortized or otherwise deducted or recovered for federal income tax purposes. . . . " Further, the agreement announces: "Whereas, the parties hereto desire to resolve with finality the Tax Consideration Issues and the C Acquisition Expenditure Issues; NOW IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes." Thus, by its own terms the agreement proposes to resolve the issue of the character of the Dealer Relationship Intangible. In Hopkins a similar closing agreement preamble provided "WHEREAS, the parties wish to resolve with finality the Federal income

tax consequences of their investment in the Partnership". The court found that the taxpayer specifically agreed to have her tax liability determined by the closing agreement, and that it was her duty to reserve in the closing agreement any possible theories that she might want to later raise. Id. , 146 F.3d at 731, 733.

As stated in Paragraph 3, Exhibit 3 identifies deductions for depreciation under section 167, useful lives, and depreciation methods. Exhibit 3 sets forth intangibles which are subject to depreciation. It does not, however, include the Dealer Relationship Intangible as an intangible asset subject to depreciation. Because the Closing Agreement states as its purpose the resolution of the depreciable nature of the assets, the non-inclusion of Dealer Relationship Intangible on Exhibit 3 supports that the parties agreed that the Dealer Relationship Intangible is not depreciable.

Moreover under paragraph 7, to the extent taxpayer is allowed any depreciation deductions it will also be allowed deductions for depreciation for any additional unadjusted tax basis added to the acquired asset as shown on Exhibit 6. On Exhibit 6 the Dealer Relationship Intangible is allocated additional unadjusted tax basis. However under the column for useful lives, depreciation/amortization method and amount of deductions for depreciation for taxable years Date 2 through Date 7, nothing is shown for the Dealer Relationship Intangible. Therefore, the Dealer Relationship Intangible clearly is not depreciable in that Exhibit 6 would show depreciation for the Dealer Relationship Intangible to the extent any was allowed.

Even more fatal to taxpayer's argument is paragraph 8 which sets forth the treatment for Dealer Relationships: "The Taxpayer will be entitled to deduct such aggregate amount allocated to the Acquired Asset identified as 'Dealer Relationships' on Exhibits 2 and 6 attached hereto upon such time as the last C Dealer has ceased the business of selling and servicing the Taxpayer's new agricultural equipment. . . . " By allowing basis recovery only upon the cessation of all dealer relationships, the agreement acknowledges that the Dealer Relationship Intangible is a nondepreciable intangible.

The loss allowed at the cessation of the Dealer Relationships is a section 165 loss. Contrary to taxpayer's assertion, although section 165(f) addresses losses from sales or exchanges of capital assets, it does not limit section 165 losses to only sales or exchanges of capital assets. For example, worthless securities losses are losses from capital assets and they are allowed under section 165(g).

The Closing Agreement purports to resolve the issue of the depreciation of acquired assets. The Exhibits set forth which assets could be depreciated. The Dealer Relationship Intangible was not included. Paragraph 8 states precisely when the basis in the Dealer Relationships may be recovered. It does not allow for depreciation. If that issue were unagreed, it could have been expressly reserved. It was not. Taxpayer argues from an alleged absence of language that the Dealer

Relationship Intangible is depreciable whereas we can point to three paragraphs, two exhibits and the preamble to support the interpretation that the dealership relationship intangible is not of a depreciable character. (See Overhauser v. United States, 45 F.3d 1085, 1088 (7th cir. 1995) ("There is no purchase in the language of the agreement for the taxpayer's position, whereas the government's has the support" of the language.)) Moreover the contract is not ambiguous if meaning can be inferred by the court from the contract. Id. Read in its entirety, the plain meaning of the Closing Agreement clearly reflects an agreement by the parties that the Dealer Relationship Intangible was of a nondepreciable character.

To the extent resort to extrinsic evidence is appropriate, it should be noted that the Closing Agreement was executed by both parties in Date 4. The Service prevailed on a similar customer-based intangible issue in Newark Morning Ledger v. United States in Date 5. Newark Morning Ledger v. United States, 945 F.2d 555 (3rd Cir. 1991). The Supreme Court did not reverse and hold against the Service's position until Date 6. Newark Morning Ledger v. United States, 507 U.S. 546 (1993). Thus, during the time frame of the negotiations concerning the Closing Agreement, it was the Service's position that the Dealer Relationship Intangible was not depreciable as a separate asset, but was nondepreciable.

Thus, when the Closing Agreement lists Dealer Relationships as an intangible asset on Exhibit 2, but excludes it from the list of depreciable intangible items on Exhibit 3, this reflects that the parties have agreed to not treat the Dealer Relationship Intangible as a depreciable asset. This is further borne out in Exhibit 6 which shows no useful life, amortization method, or amount of amortization deduction for Dealer Relationships. An examination of the Closing Agreement evaluated by its terms and the state of the law at the time it was entered into should not inquire into the subsequent Supreme Court holding in Newark Morning Ledger, other subsequent decisions on this issue, or later recognition by the Service of customer based intangible assets as depreciable assets.

Determination of the Character of the Dealer Relationship Intangible

For an intangible asset to qualify for a depreciation deduction, a taxpayer must prove that 1) The asset can be valued and 2) The asset had a useful life, the duration of which could be ascertained with reasonable accuracy. Newark Morning Ledger, 507 U.S. at 566. The determination is a factual one. Id. It is our understanding that there is no issue between the parties that the asset had an ascertainable value.

To establish the life of an intangible Treasury Regulation § 1.167(a)-1(b) provides:

> For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the

> taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments.

Thus, in order to determine the life of the Dealer Relationship Intangible, reference to taxpayer's experience with the asset is necessary. The reasonableness of taxpayer's claim should be determined upon the basis of conditions known to exist at the end of the first taxable period when the depreciation is claimed. Banc One Corp. v. Commissioner, 84 T.C. 476, 499-500 (1985). Depreciable life is computed prospectively, not retrospectively. Id. In our case, the relevant period would be the first taxable year in which taxpayer could have asserted a deduction for the Dealer Relationship Intangible, i.e. Date 2, the year B acquired the Dealer Relationship Intangible from C. Hence the relevant experience would be C's experience with the longevity of its dealer relationships. Review of several years of C's records is necessary to develop the basic data to reasonably support an assertion of a depreciable life, if any.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

ASSISTANT CHIEF COUNSEL

By: _____
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