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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSISTANT REGIONAL COUNSEL (LC)

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

SUBJECT: AMORTIZATION OF INTANGIBLES

This Field Service Advice responds to your memorandum dated August 18, 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

Taxpayer = .
Year 1 =
Year 2 =
Act =

Section =
Subsection =
Paragraph 1 =
Paragraph 2 =
TAM =
=

ISSUES

1. Whether the intangibles at issue, in particular Taxpayer's favorable financing, are assets that may be amortized under I.R.C. § 167.

2. Assuming the intangibles are amortizable assets, whether the amount subject to amortization is the adjusted cost basis of such assets on

January 1, Year 2, the date Taxpayer became a taxable entity pursuant to Act, or the fair market value of such assets on that date.

3. Assuming amortization is otherwise permissible under section 167 and under the Act, whether Taxpayer is entitled, under section 263 concepts, to current deductions with respect to similar items acquired after January 1, Year 2.

CONCLUSIONS

1. Favorable financing is not a valuable asset used in Taxpayer's trade or business or for the production of income.

2. For purposes of section 167, the basis of the intangible items identified by Taxpayer is their cost.

3. If section 167 entitles Taxpayer to amortize its intangible items, the cost basis of the items is the amount capitalized pursuant to section 263, and Taxpayer is not entitled to current deductions with respect to similar items acquired after January 1, Year 2.

FACTS

A detailed exposition of the facts surrounding Taxpayer's operations is set forth in a previously-rendered TAM. For our purposes, those facts are summarized here.

Taxpayer was created by Congress in Year 1. From its inception until Year 2, it was exempt from all federal, state, and local taxes (other than real property taxes). It was made subject to federal income tax, effective January 1, Year 2, by Act. The issues presented herein revolve around that transition.

In operation, Taxpayer links residential mortgages meeting specific guidelines from a designated group of lenders with the financial capital markets. It accomplishes this objective by buying mortgages from lenders (originators), pooling these obligations, and issuing securities identified with specific pools to the investing public. Taxpayer does not actually originate loans.

For tax purposes, Taxpayer contends that certain of its intangible assets acquired before 1985 qualify for amortization, and that the basis on which amortization is to be computed is fair market value, as opposed to the usual rule of adjusted cost basis under section 167(c). Taxpayer's adjusted cost basis in the disputed intangible assets as of January 1, Year 2, would appear to be zero, or certainly a good deal less than the fair market values asserted.

Among the intangible assets for which Taxpayer has claimed amortization is its favorable financing. The favorable financing issue pertains to Taxpayer's loan obligations where it's cost of funds for the remainder of the loan term (as of the date Taxpayer became taxable) is below market. According to Taxpayer, the below-market borrowings are in four categories: (1) notes and bonds payable, (2) subordinated debt (capital debentures and zero coupon bonds), (3) collateralized mortgage obligations ("CMOs"), and (4) guaranteed mortgage certificates ("GMCs"). Taxpayer claims to have arrived at its valuations of favorable financing with a discounted cash flow approach. At the present time, we express no opinion regarding the manner of valuation.

LAW AND ANALYSIS

Issue 1

Section 167(a) of the Internal Revenue Code 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) (1) of property used in a trade or business, or (2) of property held for the production of income. The Act does not make any reference to intangible assets. However, the regulations under section 167 discuss the depreciation of intangible assets.

Treas. Reg. § 1.167(a)-3 of the Income Tax Regulations provides that if an intangible asset 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, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No deduction for depreciation is allowable with respect to goodwill.[1]

Taxpayer argues that its below-market financing is a valuable intangible asset having a limited useful life ascertainable with reasonable accuracy. The earlier TAM set forth the position that favorable financing is not able to be amortized under section 167 because favorable financing is not a valuable asset used in Taxpayer's trade or business or for the production of income. Favorable financing represents Taxpayer's obligation to pay interest at rates lower than those it could obtain as of January 1, Year 2. The TAM reasoned that an obligation to pay money is not a valuable asset.

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[1] Section 197 of the Internal Revenue Code, as enacted under OBRA '93, which allows a 15-year amortization for goodwill and certain other intangibles acquired after August 10, 1993, is inapplicable under the facts of this case.

Taxpayer relies on Citizens and Southern Corp. v. Commissioner, 91 T.C. 463, aff'd per curiam 900 F.2d 266 (11th Cir. 1991) and IT&S of Iowa v. Commissioner, 97 T.C. 496 (1991), both concerning the amortization of core deposit intangibles, for the proposition that value attributable to below-market use of money is property for purposes of section 167. Core deposits are customer-based intangibles representing stable deposits that banks expect to retain for extensive lengths of time. In Citizens and Southern, the Tax Court concluded that although core deposits are a liability, deposit base is an asset. Until depositors withdraw their funds, the bank will be able to invest these funds. The benefit that flowed from the continued use of the funds was the asset the court allowed to be set up and depreciated. Although the deposits appeared on the liability side of the balance sheet, they created value as a depositor relationship to the extent that their cost was more attractive than higher-cost deposits. Citizens and Southern, 91 T.C. at 490.

The instant case is distinguishable from core deposit intangibles in that no asset is created by virtue of Taxpayer's obligations under the debt instruments. When Taxpayer issued the debt instruments, it presumably issued them at the market rate of interest. Between the time Taxpayer incurred the obligations and the time of the Act, interest rates fluctuated. Taxpayer identified a portion of its debt obligations which bore a lower rate of interest than market on January 1, Year 2. Such an identification, however, does not create an asset. Taxpayer is attempting to adjust the asset side of its balance sheet to account for an overstatement in fair market value terms of its liabilities. This type of adjustment has been previously denied by the Tax Court in R.M. Smith, Inc. v. Commissioner, 591 F.2d 248, 254 (3rd Cir. 1979) aff'g 69 T.C. 317 (1977), cert. denied, 444 U.S. 828 (1979). In calculating the total purchase price for capital stock partially paid by a promissory note under the residual method, the court disallowed adjustments to the face value of the note when it was apparent that because of the low interest rate, the face value did not equal the note's fair market value.[2] Moreover, the tax law generally does not recognize the present value of debt for purposes of determining basis. See also Mayerson v. Commissioner, 47 T.C. 340 (1966), acq. 1969-1 C.B. 21.

When a taxpayer can establish that it has acquired an intangible asset with a determinable basis and a reasonably ascertainable useful life, and section 167 is applicable, the taxpayer is entitled to amortize the asset. Newark Morning Ledger Co. v. Commissioner, 507 U.S. 546 (1993). However, in this case, Taxpayer has mischaracterized the difference between the face amount of the obligations and their current market value as of January 1, Year 2 as a separate and distinct asset.

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[2]The unstated interest rules under section 483 of the Code did not apply.

1. Even if favorable financing is an asset, it is not an asset that qualifies for fair market value basis under Section of Act.

The "favorable financing" at issue is a component of debt instruments issued by Taxpayer. Congress enacted specific provisions for taxpayers to claim deductions associated with debt instruments. See, e.g., section 163 and sections 1271-1275 of the Code. Therefore, if a deduction may be claimed for favorable financing, it should be claimed under these specific provisions, not under general recovery provisions such as section 167.

When Congress passed Section of Act to make Taxpayer taxable, it generally required Taxpayer to restate the basis of all of its assets to their fair market value, but did not require Taxpayer to restate the adjusted issue price of all outstanding debt to the fair market value of the burden represented by the debt. For debt that had been originally issued in a lower interest rate environment (the debt for which Taxpayer is claiming the existence of a favorable financing asset), restating the adjusted issue price would have given taxpayer additional deductions under section 163 to the extent that the stated principal on the debt exceeded the new adjusted issue price. See section 163(e). By restating bases but not adjusted issue prices, however, Congress effectively denied these section 163 deductions. Taxpayer's claimed section 167 deductions are an attempt to avoid the consequences of that Congressional decision. The fact that Congress chose not to extend these adjustments to Taxpayer's outstanding debt should be respected.

In another context, Taxpayer has claimed amortization deductions under section 167 for "favorable financing" to effect an end-run around Congressional action that prevented deductions under section 163 for essentially the same item. Usually, amortization of favorable financing is claimed by a taxpayer that has assumed debt as part of the purchase of a business. When the stated interest rate on the assumed debt was sufficiently lower than market interest rates, the debt might have been treated as having been reissued for an amount less than the stated principal amount, thus producing original issue discount deductions under section 163 for the assuming party. The enactment of section 1274(c)(4), however, barred these deductions by treating the taxpayer as assuming the full stated principal of the debt, regardless of whether market interest rates had increased since the debt was originally issued. Taxpayer sought to avoid this consequence by pointing to the increase in rates, asserting the existence of a "favorable financing" asset, and claiming deductions under section 167 as a substitute for the barred deductions under section 163.

Allowing Taxpayer to claim deductions under section 167 for a "favorable financing asset" would circumvent the Code's general proscription against allowing section 163 deductions in these circumstances. As such, Taxpayer's claims should be denied.

Issue 2

You ask whether the conclusion of the TAM with regard to the proper basis of Taxpayer's intangible assets remains the same. We continue to agree that the position set forth therein is correct.

The Act which subjected Taxpayer to federal income tax provided special basis rules to be used in determining gain or loss and to be used in depreciating tangible property, as follows:

Adjusted Basis of Assets.—

> (A) In General.—Except as otherwise provided in subparagraph (B), the adjusted basis of any asset of the [Taxpayer] held on January 1, [Year 2], shall–
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> > (i) for purposes of determining any loss, be equal to the lesser of the adjusted basis of such asset or the fair market value of such asset as of such date, and
> >
> > (ii) for purposes of determining any gain, be equal to the higher of the adjusted basis of such asset or the fair market value of such asset as of such date.
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> (B) Special Rule for Tangible Depreciable Property.—In the case of any tangible depreciable property which–
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> > (i) is of a character subject to the allowance for depreciation provided by section 167 of the Internal Revenue Code of 1954, and
> >
> > (ii) is held by the [Taxpayer] on January 1, [Year 2],
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> the adjusted basis of such property shall be equal to the lesser of the basis of such property or the fair market value of such property as of such date.

Section, Subsection, Paragraph 1 of Act sets forth the rules for calculating adjusted basis only for purposes of determining gain or loss, and a special rule for purposes of determining gain or loss on tangible depreciable property. This section does not provide any guidance for determining the proper adjusted basis in depreciating intangible property. Section, Subsection, Paragraph 2 of Act further provides:

> Adjusted Basis.—For purposes of this subsection, the adjusted basis of any asset shall be determined under part II of subchapter O of the Internal Revenue Code of 1954.

Part II of subchapter O of the Internal Revenue Code (Code) sets forth basis rules of general application.

As Section, Subsection of Act provides no rule or guidance for calculating the adjusted basis for purposes of depreciating intangible property, the adjusted basis must be determined under existing provisions of the Code. Section 167(c) provides that the basis for depreciation shall be the adjusted basis provided in section 1011, for the purpose of determining the gain on the sale or other disposition of the property. Section 1011 provides that the adjusted basis for determining gain or loss shall be the basis as determined under section 1012, or other applicable sections of the subchapter[3], and adjusted as provided in section 1016. Sections 1011, 1012 and 1016 are found in part II of subchapter O, the same part and subchapter referred to in Section, Subsection, Paragraph 2 of Act.

Under section 1012 of the Code, the basis of property is the cost of such property. The cost basis is then adjusted under section 1016. As it relates to depreciation, section 1016(a)(2) provides that the cost basis of property shall be decreased for exhaustion, wear and tear, obsolescence, amortization, and depletion by the greater of two amounts: the amount allowed as deductions in computing taxable income, to the extent resulting in a reduction of the taxpayer's income taxes, or, the amount allowable for the years involved. If the taxpayer has not taken a depreciation deduction in any prior taxable year, the adjustment to the basis of the property for depreciation allowable is to be determined by using the straight-line method of depreciation. Treas. Reg. § 1.1016-3(a)(2).

Thus, if the cost of an intangible asset is capitalized and added to basis under section 1012, under the plain language of section 1016(a)(2) Taxpayer must adjust the basis of any intangible property it seeks to depreciate by the amount of depreciation allowable for that asset since acquisition date. This is true regardless of the fact that Taxpayer did not actually claim any deductions for depreciation in

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[3]Section 1011 provides in its entirety:

> The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

the years when Taxpayer was not subject to tax. Taxpayers are not required to receive a tax benefit before basis is adjusted for allowable, but not taken, depreciation.

The legislative history of section 1016 supports the foregoing proposition. In 1952, the predecessor to section 1016(a)(2) was amended in order to correct a Supreme Court interpretation of an earlier amendment added by the Revenue Act of 1932. The intended purpose of the 1932 amendment was to prevent a taxpayer from claiming a double deduction by requiring any excessive depreciation claimed and subsequently allowed to reduce the basis of the property. However, in Virginian Hotel Corp. v. Helvering, 319 U.S. 523 (1943), the Supreme Court construed the 1932 amendment to mean that even in the case of a taxpayer who had received no tax benefit from mistakenly claiming excessive depreciation in earlier years now closed, the taxpayer was required to reduce his basis in the depreciable property by that amount. The 1952 amendment, in relevant part, corrected the seemingly unjust interpretation in Virginian Hotel Corp. by providing that the adjusted basis of property is to be reduced by excessive depreciation shown in a return only to the extent that such excessive depreciation resulted in a reduction in the taxpayer's taxes. The determination of whether a deduction resulted in a tax benefit is only necessary when "excessive" depreciation is claimed; when a taxpayer claims an appropriate deduction for depreciation, for basis adjustment purposes, it is immaterial whether the deduction results in a tax benefit to the taxpayer. Consistent with this proposition is the fact that a taxpayer is required to adjust basis in an asset by the amount of depreciation "allowable," even in the case where a taxpayer did not claim any deduction. The legislative history illustrates this point.

> [The] committee continues the provisions of existing law, also included in the House bill, which require that the basis of property shall be reduced in any case by amounts allowable whether or not any tax benefit is derived therefrom.

S. Rep. No. 82-1160, at 3-4 (1952).

> H.R. 3168 [1952 amendment] makes no change in the law with reference to the deduction of allowable depreciation. The law has been, and will remain, that depreciation which was allowable in a prior year must be deducted in computing basis, even though in the light of later events it develops that the depreciation in such prior year was actually less than it was then properly estimated to be. And this is true regardless of whether depreciation allowable in such prior year had any effect on tax liability in the prior year. Such depreciation must be deducted even though there was no income against which it could be offset.

97 Cong. Rec. 3798 (1952) (statement of Mr. Camp).

Thus, in the instant case, the fact that Taxpayer did not receive a tax benefit from amortization in previous years is not relevant. Depreciation represents the decline in value of property that occurs over time due to wear and tear, obsolescence, amortization, exhaustion, etc. Depreciation is centered on the concept that property has a limited useful life. The Supreme Court has noted that "the primary purpose" of an annual depreciation deduction is "to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use (excluding maintenance expense) of the asset to the periods to which it contributes." Newark Morning Ledger v. United States, 507 U.S. 546, 553 (1993) (quoting Massey Motors, Inc. v. United States, 364 U.S. 92 (1960). Assuming Taxpayer has any amortizable intangible property, the decline in the value of such assets in Taxpayer's hands began at the time of acquisition, not at the time Taxpayer became taxable. Thus, Taxpayer is required under section 1016(a)(2) to calculate the allowable depreciation for its intangible assets from the year acquired and adjust the basis of these assets accordingly in order to meaningfully allocate the cost entailed in the use of the asset to the period to which it contributes.

Specifically in regard to the amortizable basis of the claimed "favorable financing" asset, we note that even if favorable financing is deemed an asset, it is not an asset that qualifies for fair market value basis under Section of Act. Again, Section of Act provides that except as otherwise provided in subparagraph (B) (relating to a special rule for tangible depreciable property), the adjusted basis of any asset of Taxpayer shall, **for purposes of determining any gain**, be equal to the higher of the adjusted basis of such asset or the fair market value of such asset as of such date. (emphasis added). This provision of the Act was to ensure that any pre-Year 2 appreciation in the value of Taxpayer's assets would not be taken into account for tax purposes. Even if Taxpayer's favorable financing constitutes an asset, however, it could never produce "gain," since a taxpayer's transactions in debt that it has issued can produce only cancellation of indebtedness ("COD") income or additional interest deductions. Since there is no way that "favorable financing" could ever produce "gain" or "loss," Section of Act arguably doesn't apply to favorable financing.

Issue 3

As you requested, we have reviewed the position taken in the TAM and asked that the IT&A branch of Field Service do the same. In both cases, we believe the position set forth therein, that in the event amortization of Taxpayer's intangible assets is allowed, any expenditures in later years that create or enhance the intangible assets must be capitalized and not currently deducted, is correct.

In substance, if an item, e.g., a customer relationship, created in 1984 or earlier, rose to the level of an asset under Section of Act, then there is little reason to question whether a similar item created in a later year is also an asset. Thus, the costs of creating or enhancing that asset should also be capitalized into basis. The Taxpayer's argument that the alternative position is somehow based on some sort of capitalization election misses the point. The duty of consistency called for under the alternative position relates to the treatment of the item as a separately identifiable asset–not to the capitalization of the expenditures attributable to that item. As stated above, the position stated in the TAM stands.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

Please call if you have any further questions.

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