

# Notice of Proposed Rulemaking and Notice of Public Hearing

## Amortization of Intangible Property

REG-209709-94

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the amortization of certain intangible property. The proposed regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), and affect taxpayers who acquired intangible property after August 10, 1993, or made a retroactive election to apply OBRA '93 to intangibles acquired after July 25, 1991. This document also provides notice of a public hearing on the proposed regulations.

DATES: Comments must be received by April 16, 1997. Requests to appear and outlines of oral comments to be presented at the public hearing scheduled for May 15, 1997, must be received by April 24, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-209709-94), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-209709-94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.ustreas.gov/prod/tax\\_regs/comments.html](http://www.irs.ustreas.gov/prod/tax_regs/comments.html). The public hearing will be held in the Commissioner's Conference Room (Room 3313), Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, John Huffman at (202) 622-3110; concerning submissions and the hearing, Michael Slaughter at (202) 622-8452 (not toll-free numbers).

## SUPPLEMENTARY INFORMATION:

### *Background*

This document contains proposed regulations under sections 167(f) and 197. These provisions were added to the Internal Revenue Code of 1986 (the Code) by section 13261 of OBRA '93, and apply to intangible property acquired after August 10, 1993 (or after July 25, 1991, if a valid retroactive election to apply OBRA '93 to intangibles has been made pursuant to § 1.197-1T).

The proposed regulations provide definitions and rules for amortization of intangible property subject to sections 197 and 167(f). On June 24, 1994, the IRS published Announcement 94-92 (1994-28 I.R.B. 139) in the **Federal Register** (59 FR 32670) inviting comments under section 197 relating to the amortization of goodwill and certain other intangibles that should be addressed in proposed regulations. The IRS has reviewed these comments and has addressed certain issues raised in the comments in the proposed regulations. However, because these comments were received in anticipation of the issuance of these proposed regulations, and because these regulations are subject to further comment and a public hearing, no attempt has been made to describe all of the principal comments that are not reflected in these regulations or the reasons therefor.

### *Explanation of Provisions*

#### *1. General overview*

Sections 167(f) and 197 provide comprehensive rules for the depreciation and amortization of many intangible assets. Intangible assets subject to section 197 are broadly defined to include most intangible assets acquired in connection with the acquisition of a trade or business and certain other separately acquired intangible assets. The adjusted basis of an amortizable section 197 intangible must be amortized over a 15-year period. Certain other intangible assets are excluded from section 197 for various reasons. In some cases, such as stock and partnership interests, the asset is property of a character that is not subject to an allowance for depreciation because it represents a permanent investment that can only be recovered through disposition of the asset (includ-

ing worthlessness). In other cases, such as computer software, purchased mortgage servicing rights, service and supply contracts, and certain other contracts or rights with a fixed duration, other cost recovery methods were prescribed by the OBRA '93 amendments. In still other cases, such as motion picture films, television series, books, and sound recordings, other cost recovery methods that were in effect prior to OBRA '93 are more appropriate under the circumstances. Section 167(f) provides alternative methods of depreciation for certain of the intangibles excluded from the application of section 197.

The proposed regulations provide guidance for certain intangible property subject to sections 167(f) and 197. The section 167(f) proposed regulations provide rules for intangible property subject to the allowance for depreciation under section 167 and specifically excluded from section 197. These intangible assets include certain computer software, rights to receive tangible property or services, rights of fixed duration, patents, copyrights, and mortgage servicing rights. These proposed regulations reserve guidance on the method of depreciating the cost of separately acquired rights to receive tangible property or services where the amount of the property or services to be received is not specified. The IRS invites comments on possible methods of depreciation in these cases.

Because section 197 provides a method of amortization and, except in the case of certain covenants not to compete, governmental licenses, permits and other rights, and contracts for the use of section 197 intangibles, does not alter the rules for determining the basis of an asset, section 197 generally does not apply to amounts that would otherwise be deductible. For example, section 197 does not generally apply to the costs of advertising because, in most cases, these costs are deductible under other provisions of the Code. See Rev. Rul. 92-80 (1992-2 C.B. 57). In addition, section 197 does not apply to costs that would not, under general principles of Federal income tax law, be included in the basis of a section 197 intangible. For example, if a taxpayer borrows money to purchase the assets of a trade or business (including amortizable section 197 intangibles) and incurs fees in connection with the loan, these costs are

generally amortized over the term of the loan rather than under the rules of sections 167(f) and 197. As a further example, if the amortizable section 197 intangibles acquired in the transaction include a favorable supply contract, the amortizable basis in the contract does not include amounts required to be paid for goods to be received pursuant to the contract.

In addition, section 197 does not apply to any amount for which a deduction would be disallowed under other provisions of the Code, such as section 162(k) (relating to amounts paid or incurred by a corporation in connection with the acquisition of its stock or the stock of a related person).

No inference should be drawn from any provision in the proposed regulations concerning the classification of any section 197 intangible as property, or whether any section 197 intangible is treated as tangible or intangible property, for other purposes of the Code. Furthermore, no inference should be drawn from any provision in the proposed regulations regarding (a) whether any section 197 intangible that is not an amortizable section 197 intangible may be amortized or depreciated under any provision of the Code other than section 197, or (b) the proper method for determining any allowance therefor. Finally, no inference should be drawn from any provision in the proposed regulations concerning whether any section 197 intangible (or any interest therein) has been purchased, leased, or licensed for Federal income tax purposes.

## 2. Section 197 intangibles

The proposed regulations define section 197 intangibles (subject to certain exceptions) as goodwill, going concern value, workforce in place, information base, know-how, customer- and supplier-based intangibles, governmental licenses and permits, covenants not to compete and other similar arrangements, franchises, trademarks, trade names, and contracts for the use of the foregoing assets.

### A. Covenants not to Compete

Some commentators in response to Announcement 94-92 suggested that a covenant not to compete relating to the redemption of stock or a partnership interest from a departing stockholder or partner should be excluded from section 197 because this situation does not involve the acquisition of a trade or

business. The legislative history provides, however, that section 197 applies to a covenant not to compete acquired with the assets of a trade or business, the stock in a corporation, or an interest in a partnership engaged in a trade or business. Consequently, the proposed regulations do not provide for this exception. In this regard, the proposed regulations provide that for purposes of section 197(f)(1)(B), the disposition or cancellation of redeemed stock of a corporation will not cause the covenant to be written off faster than over the 15-year amortization period provided for under section 197 (in the case of a covenant to which section 162(k) does not apply).

### B. Contracts for the Use of Section 197 Intangibles

Some commentators also requested guidance on the extent to which contracts for the use of section 197 intangibles would be subject to section 197, in some cases suggesting that an intangible was not subject to section 197 unless the taxpayer obtained ownership of property for Federal income tax purposes. However, it is sometimes difficult to determine whether the terms of an agreement confer ownership, for Federal income tax purposes, of property, and the IRS and Treasury believe that the purposes of section 197 could be circumvented through the use of such agreements. Accordingly, the proposed regulations provide that contracts for the use of section 197 intangibles will also be treated as section 197 intangibles. Contracts that are so treated may, however, be excluded under either section 197(e)(4)(B) or (D) on the basis that they are contracts for the receipt of property or services, contracts having a fixed duration, or contracts having a fixed amount and recovered on a unit-of-production method or other similar method.

## 3. Intangibles excluded from section 197

### A. Computer Software

Section 197 intangibles do not include computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified. The proposed regulations provide a safe harbor for purposes of determining whether computer software has been substantially modified. Under the safe harbor,

computer software has not been substantially modified if its capitalized cost does not exceed the greater of \$2,000 or 125 percent of the price at which the unmodified version of the software is readily available to the general public.

The proposed regulations incorporate some of the provisions of Revenue Procedure 69-21 (1969-2 C.B. 303), involving the treatment of costs of computer software, and modify other provisions to the extent necessary to conform to the amortization rules provided under sections 197 and 167(f). Consequently, if costs for developing computer software that the taxpayer has elected to treat as deferred expenses under section 174(b) result in the development of a self-created intangible excluded under section 197(c)(2) and subject to the allowance for depreciation under section 167(a), deductions for the unrecovered expenditures are subject to section 167(f)(1). Computer software costs included, without being separately stated, in the cost of the computer hardware (bundled software) continue to be capitalized and depreciated as part of the computer hardware. The proposed regulations also continue to treat as currently deductible software costs properly and consistently treated as deductible (not capitalized) under § 1.162-11.

### B. Certain Separately Acquired Intangibles

Certain intangibles are excepted from section 197 if they are not acquired as part of a purchase of a trade or business. The proposed regulations clarify that, for purposes of section 197, a group of assets constitutes a trade or business if their use would constitute a trade or business under section 1060; that is, if goodwill or going concern value could under any circumstances attach to the assets. Temporary and proposed regulations under section 1060, in turn, provide that a group of assets constitutes a trade or business for purposes of section 1060 if the use of such assets would constitute an active trade or business for purposes of section 355. However, in appropriate cases, even if the use of a group of assets would not constitute an active trade or business for purposes of section 355, such assets may nevertheless constitute a trade or business for purposes of section 1060. See § 1.1060-1T(b)(2).

The IRS intends to provide additional guidance as to the circumstances under which the acquisition of a group of

assets constitutes a trade or business for purposes of section 1060 in regulations under that section. Accordingly, the proposed regulations do not provide substantive guidance on this question, except to the extent that the considerations are unique to the application of section 197. The IRS invites comments on the extent to which additional rules under section 197 may be necessary.

### C. Certain Contracts and Governmental Rights

While section 197 intangibles include licenses, permits, and other rights granted by a governmental unit or an agency or instrumentality thereof (section 197(d)(1)(D)), certain rights granted by these governmental entities are excluded from section 197 pursuant to section 197(e)(4)(B) and (D), subject to the conditions and limitations therein. Because a particular right may be described in two or more of these provisions, the proposed regulations provide guidance regarding the potential conflict between, or overlap with, these provisions. Thus, a right that would be subject to section 197 pursuant to section 197(d)(1)(D) may nevertheless be excluded if it is also described in section 197(e)(4) and meets all of the requirements for exclusion. Furthermore, a right that meets the requirements of either section 197(e)(4)(B) or section 197(e)(4)(D) is excluded from section 197 even if it fails to meet one of the requirements for the other exclusion. In addition, any license, permit, or other right granted by a governmental unit that otherwise meets the definition of a franchise under section 197(d)(1)(F), such as an FCC broadcast license or cable television franchise, is treated as a franchise under the regulations. Accordingly, these licenses do not qualify for any of the exceptions from section 197 provided under section 197(e)(4).

#### 4. *Special rules of application*

##### A. Loss Disallowance Provisions

The proposed regulations contain rules for the loss disallowance provisions set forth in section 197(f)(1). In particular, the proposed regulations provide that a taxpayer may not circumvent the loss disallowance rules, for example, by transferring some intangibles, whose adjusted basis is greater than their fair market value, to a corporation in exchange for stock in the corporation in a transaction described in section 351,

while retaining other intangibles acquired in the same or related transaction, and then selling the stock. Special rules are also provided for the application of the loss disallowance provisions in cases where a taxpayer has disposed of all of the amortizable section 197 intangibles acquired in a single transaction but is treated as having retained other amortizable section 197 intangibles solely by virtue of the retention of amortizable section 197 intangibles by a related person.

##### B. Transactions Involving Partnerships

The proposed regulations provide rules and examples relating to the treatment of section 197 intangibles acquired or transferred in certain partnership transactions, including terminations under section 708(b)(1), and the application of section 197 to the special basis adjustments of partnership property for which a section 754 or section 732(d) election is in effect. Guidance is also provided regarding the effect of curative and remedial allocations and the application of the anti-churning rules to certain partnership transactions.

In the case of the termination of a partnership under section 708(b)(1)(B) (relating to a sale or exchange of an interest), the rules contained in the proposed regulations are based on recently proposed regulations under that section, pursuant to which the new partnership is treated as having directly acquired the assets of the old partnership in exchange for the assumption of its liabilities and the issuance of interests in the new partnership. Accordingly, for purposes of section 197, the consequences of the termination of a partnership under section 708(b)(1)(B) may not be the same as the consequences of such a termination under the rules in effect at the time section 197 was enacted.

##### C. Treatment of Contingent Payments

The proposed regulations clarify that, except in the case of contingent payments, amounts paid for section 197 intangibles are treated as amounts chargeable to capital account, and the entire principal amount is amortized ratably over the 15-year amortization period beginning with the later of the month in which the intangible is acquired or the date on which the active conduct of a trade or business begins. Contingent payments for section 197 intangibles paid or incurred after the taxable year in which the intangible is

acquired are added to basis at such time and generally amortized ratably over the remaining months in the 15-year period as of the beginning of the month the amount is paid or incurred. However, in order to reduce the administrative burden that may result from a requirement to maintain separate amortization schedules for each month during the 15-year period, taxpayers are permitted to use certain simplifying conventions. In addition, any amount that is not properly included in the basis of an amortizable section 197 intangible until after the expiration of the 15-year period is amortized in full immediately upon the inclusion of the amount in the basis of the intangible. The proposed regulations refer to § 1.461-1(a)(1) for rules governing the time at which an amount may be taken into account by a taxpayer using the cash receipts and disbursements method. They refer to § 1.461-1(a)(2) for rules governing the time at which a liability is incurred and generally taken into account (for example, by treating the amount of the liability as a capital expenditure) by an accrual basis taxpayer.

#### 5. *Anti-churning Rules*

To be eligible for amortization, section 197 intangibles must qualify as amortizable section 197 intangibles. Generally, amortizable section 197 intangibles are section 197 intangibles that are acquired after August 10, 1993 (or acquired after July 25, 1991, and for which the taxpayer made a proper election under § 1.197-1T) and held in connection with the conduct of a trade or business or an activity described in section 212.

The proposed regulations provide anti-churning rules to prevent taxpayers from converting into amortizable section 197 intangibles existing goodwill, going concern value, and any other section 197 intangible for which amortization would not have been allowable prior to OBRA '93 through the use of related persons and certain other transactions. The proposed regulations define the term related person for purposes of these rules.

The proposed regulations also contain provisions for the exception to the anti-churning rules in situations where the seller elects to recognize gain and agrees to pay a specified amount of tax. The regulations reserve guidance on the manner of making this election. The IRS intends to issue a revenue procedure in

order to provide interim guidance to taxpayers on the manner of making this election, and the final regulations will include the relevant provisions of this revenue procedure.

The proposed regulations contain both an anti-churning anti-abuse rule and a general anti-abuse rule that provide that the Commissioner may recast any transaction if one of its principal purposes is to avoid the purposes of section 197.

#### 6. Assumption Reinsurance Transactions

Section 197(f)(5) provides special rules for section 197 intangibles resulting from assumption reinsurance transactions. The proposed regulations reserve guidance on certain aspects of these transactions. The IRS invites comments on the extent to which additional guidance on the application of section 197 to these transactions may be necessary.

#### 7. Proposed Effective Dates

The regulations for sections 167(f) and 197 are proposed to be effective on the date on which the final regulations are published in the **Federal Register**. Regulations to implement section 197(e)(4)(D) (separately acquired contracts of fixed duration or amount) are proposed to be effective August 11, 1993, for property acquired after August 10, 1993 (or July 26, 1991, if a valid retroactive election has been made under § 1.197-1T).

#### 8. Accounting Method Changes

A change in the method of depreciation or amortization of intangibles is a change in method of accounting that requires the consent of the Commissioner of Internal Revenue under section 446(e). To obtain this consent, a Form 3115, Application for Change in Accounting Method, generally must be filed within 180 days after the beginning of the taxable year in which the proposed change is to be made. Taxpayers that have adopted a method of accounting for certain intangibles may need to change their method of accounting to comply with the final regulations.

#### 9. Basis Allocation Rules

In separate notices the IRS and Treasury are issuing temporary and proposed amendments to the temporary regulations under sections 1060 and 338(b). The existing temporary regulations establish a four-class system for allocating

basis to individual assets in the case of a direct acquisition of assets constituting a trade or business or a deemed acquisition of assets as the result of an election under section 338. Under this system, assets in the nature of goodwill and going concern value are included in Class IV, while other intangible assets, whether or not amortizable, are included in Class III. Each successive class is allocated basis under a residual method, subject to a fair market value limitation for all classes except Class IV. After basis has been allocated to each class in the aggregate, assets within each of the first three classes are allocated basis on a proportional method. This system is inconsistent with the policies of section 197, which prescribes uniform treatment for all amortizable section 197 intangibles. Accordingly, appropriate modifications are being proposed.

#### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted (in the manner described in ADDRESSES) timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 15, 1997, at 10 a.m. in the Commissioner's Conference Room (Room 3313), Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC 20224. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit comments and an outline of the topics to be discussed and the time to be devoted to each topic (in the manner described in ADDRESSES) by April 16, 1997. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### Drafting Information

The principal author of these regulations is John Huffman, Office of Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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#### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*  
Section 1.197-2 also issued under 26 U.S.C. 197(g). \* \* \*

Par. 2. Section 1.167(a)-3 is amended by adding a sentence at the end to read as follows:

#### § 1.167(a)-3 Intangibles.

\* \* \* See §§ 1.197-2 and 1.167(a)-14 for amortization of goodwill and certain other intangibles acquired after August 10, 1993, or after July 25, 1991, if a valid retroactive election under § 1.197-1T has been made.

Par. 3. Section 1.167(a)-6 is amended by adding two sentences at the end of paragraph (a) to read as follows:

#### § 1.167(a)-6 Depreciation in special cases.

(a) \* \* \* See § 1.167(a)-14(c)(4) for depreciation of a separately acquired interest in a patent or copyright described in section 167(f)(2) acquired after the date on which the final regula-

tions are published in the Federal Register. See § 1.197-2 for amortization of interests in patents and copyrights that constitute amortizable section 197 intangibles.

\* \* \* \* \*

Par. 4. Section 1.167(a)-14 is added to read as follows:

*§ 1.167(a)-14 Treatment of certain intangible property excluded from section 197.*

(a) *Overview.* This section provides rules for the amortization of certain intangibles that are excluded from section 197 (relating to the amortization of goodwill and certain other intangibles). These excluded intangibles are specifically described in § 1.197-2(c)(4), (6), (7), (11), and (13) and include certain computer software and certain other separately acquired rights, such as rights to receive tangible property or services, patents and copyrights, rights of fixed duration or amount, and certain mortgage servicing rights. Intangibles for which an amortization amount is determined under section 167(f) and intangibles otherwise excluded from section 197 (for example, self-created intangibles described in § 1.197-2(d)(2)) are amortizable only if they qualify as property subject to the allowance for depreciation under section 167(a).

(b) *Computer software*—(1) *In general.* The amount of the deduction for computer software described in section 167(f)(1) and § 1.197-2(c)(4) is determined by amortizing the adjusted basis of the computer software using the straight line method described in § 1.167(b)-1 (except that its salvage value is treated as zero) and an amortization period of 36 months beginning with the month that the computer software is placed in service. If costs for developing computer software that the taxpayer properly elects to defer under section 174(b) result in the development of property subject to the allowance for depreciation under section 167, the rules of this paragraph (b) will apply to the unrecovered costs. In addition, this paragraph (b) applies to the cost of separately acquired computer software where these costs are separately stated and the costs are required to be capitalized under section 263(a).

(2) *Exceptions.* Paragraph (b)(1) of this section does not apply to the cost of computer software properly and consistently treated as currently deductible (that is, not capitalized) under § 1.162-

11. The cost of acquiring an interest in computer software that is included, without being separately stated, in the cost of the hardware or other tangible property is treated as part of the cost of the hardware or other tangible property that is capitalized and depreciated under other applicable sections of the Internal Revenue Code.

(c) *Certain interests or rights acquired separately*—(1) *Certain rights to receive tangible property or services.* The amount of the deduction for a separately acquired right to receive tangible property or services under a contract or from a governmental unit (specified in section 167(f)(2) and § 1.197-2(c)(6)) is determined as follows:

(i) *Amortization of fixed amounts.* The cost of acquiring a right to receive a fixed amount of tangible property or services is amortized for each taxable year by multiplying the basis (as determined under section 1011) of the right by a fraction, the numerator of which is the amount of tangible property or services received during the taxable year and the denominator of which is the total amount of tangible property or services received or to be received under the terms of the contract or governmental grant. For example, if a taxpayer acquires a favorable contract right to receive a fixed amount of raw materials during an unspecified period, the taxpayer must amortize the cost of acquiring the contract right by multiplying the total cost by a fraction, the numerator of which is the amount of raw materials received under the contract during the taxable year and the denominator of which is the total amount of raw materials received or to be received under the contract.

(ii) *Amortization of unspecified amount over fixed period.* The cost of acquiring a right to receive an unspecified amount of tangible property or services over a fixed period is amortized ratably over the period of the right.

(iii) *Amortization in other cases.* [Reserved]

(2) *Rights of fixed duration or amount.* The amount of the deduction for a separately acquired right of fixed duration or amount received under a contract or granted by a governmental unit (specified in section 167(f)(2) and § 1.197-2(c)(13)) and not covered by paragraph (c)(1) of this section is determined as follows:

(i) *Rights of a fixed amount.* The cost of acquiring a right of a fixed amount is amortized for each taxable year by mul-

tiplying the cost of the right by a fraction, the numerator of which is the amount received or delivered during the taxable year and the denominator of which is the total amount to be received or delivered (including amounts received or delivered prior to the close of the taxable year) under the terms of the contract or governmental grant.

(ii) *Rights of unspecified amount and fixed duration of less than 15 years.* The cost of acquiring a right of an unspecified amount and a fixed duration of less than 15 years is amortized ratably over the period of the right.

(3) *Application of renewals.* (i) For purposes of paragraphs (c)(1) and (2) of this section, the duration of a right under a contract (or granted by a governmental unit) includes any renewal period if, based on all of the facts and circumstances in existence at any time during the taxable year in which the right is acquired, the facts clearly indicate a reasonable expectancy of renewal.

(ii) The mere fact that a taxpayer will have the opportunity to renew a contract right or other right on the same terms as are available to others, in a competitive auction or similar process that is designed to reflect fair market value and in which the taxpayer is not contractually advantaged, will generally not be taken into account in determining the duration of such right provided that the bidding produces a fair market value price comparable to the price that would be obtained if the rights were purchased immediately after renewal from a person (other than the person granting the renewal) in an arm's-length transaction.

(iii) The cost of a renewal not included in the terms of the contract or governmental grant is treated as the acquisition of a separate intangible asset.

(4) *Patents and copyrights.* The amount of the deduction for a separately acquired interest in a patent or copyright described in section 167(f)(2) and § 1.197-2(c)(7) is equal to the purchase price paid or incurred during the year if the purchase price is payable on at least an annual basis as either a fixed amount per use or a fixed percentage of the revenue derived from the use of the patent or copyright. Otherwise, the cost or other basis of a separately acquired patent or copyright (or an interest therein) is depreciated ratably over its remaining useful life. If a patent or copyright becomes valueless in any year before its legal expiration, the adjusted basis may be deducted in that year.

(5) *Applicable rules and conventions.* The period of amortization under paragraphs (c)(1) through (4) of this section begins when the intangible is placed in service. For other applicable rules, see § 1.197-2(f).

(d) *Mortgage servicing rights.* The amount of the deduction for mortgage servicing rights described in section 167(f)(3) and § 1.197-2(c)(11) is determined by using the straight line method described in § 1.167(b)-1 (except that the salvage value is treated as zero) and an amortization period of 108 months. Mortgage servicing rights are not depreciable to the extent the rights are stripped coupons under section 1286. An event that renders mortgage servicing rights wholly worthless is considered a disposition of the rights. For purposes of determining the deduction for mortgage servicing rights and any loss from the sale, exchange, or other disposition of the rights, rights to service a pool of mortgages are treated as a single asset. Thus, if some (but not all) mortgages in a pool prepay and the taxpayer retains rights to service the remaining mortgages in the pool, no loss is recognized by reason of the prepayment. The adjusted basis of the mortgage servicing rights is not affected by the unrecognized loss.

(e) *Effective date.* This section is applicable on the date final regulations are published in the **Federal Register** except that § 1.167(a)-14(c)(2) (depreciation of the cost of certain separately acquired rights) and so much of § 1.167(a)-14(c)(3) as relates to § 1.167(a)-14(c)(2) are applicable August 11, 1993 (or July 26, 1991, if a valid retroactive election has been made under § 1.197-1T).

Par. 5. Section 1.197-0 is added to read as follows:

#### § 1.197-0 Table of contents.

This section lists the headings that appear in § 1.197-2.

#### § 1.197-2 Amortization of goodwill and certain other intangibles.

##### (a) Overview.

- (1) In general.
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(c) Section 197 intangibles; exceptions.

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(iv) Computer software defined.

(v) Readily available to the general public.

(5) Certain interests in films, sound recordings, video tapes, books, or other similar property.

(6) Certain rights to receive tangible property or services.

(7) Certain interests in patents or copyrights.

(8) Interests under leases of tangible property.

(i) Interest as a lessor.

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(i) In general.

(ii) Exceptions.

(10) Professional sports franchises.

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(ii) Created by the taxpayer.

(A) Defined.

(B) Contracts for the use of intangibles.

(C) Improvements and modifications.

(iii) Exceptions.

(3) Exception for property subject to anti-churning rules.

(e) Purchase of a trade or business.

(1) Goodwill or going concern value.

(2) Customer-based intangibles.

(3) Franchise, trademark, or trade name.

(i) In general.

(ii) Exceptions.

(4) Acquisitions to be included.

(5) Substantial portion.

(6) Deemed asset purchases under section 338.

(f) Computation of amortization deduction.

(1) In general.

(2) Treatment of contingent amounts.

(i) Amounts added to basis during 15-year period.

(ii) Amounts becoming fixed after expiration of 15-year period.

(iii) Time for including amounts in basis.

(3) Determination of amounts chargeable to capital account in certain cases.

(i) Covenants not to compete, rights granted by governmental units, and contracts for the use of section 197 intangibles.

(A) In general.

(B) Time for taking amounts into account.

(ii) Franchises, trademarks, or trade names and licenses, permits, and other rights granted by governmental units.

(iii) Certain reinsurance transactions.

(4) Transactions subject to section 338 or 1060.

(g) Special rules.

(1) Treatment of certain dispositions.

(i) Loss disallowance rules.

(A) In general.

(B) Certain nonrecognition transfers.

(ii) Separately acquired property.

(iii) Disposition of a covenant not to compete.

(iv) Taxpayers under common control.

(A) In general.

(B) Treatment of disallowed loss.

(2) Treatment of certain nonrecognition and exchange transactions.

(i) In general.

(A) Transfer disregarded.

(B) Application of general rule.

(ii) Transactions covered.

(iii) Certain exchanged-basis property.

(iv) Transfers under section 708(b)(1).

(A) In general.

(B) Termination by sale or exchange of interest.

(C) Other terminations.

(D) Anti-churning rules.

(v) Distributions to which section 732(d) applies.

(vi) Curative and remedial allocations under section 704(c).

(3) Application of section 754 to acquisitions of an interest in an intangible held through a partnership.

(4) Treatment of certain reinsurance transactions.

(i) In general.

(ii) Determination of adjusted basis.

(A) Acquisitions (other than under section 338) of specified insurance contracts.

(B) Other acquisitions. [Reserved]

(5) Amounts paid or incurred for a franchise, trademark, or trade name.

(6) Amounts properly taken into account in determining the cost of property that is not a section 197 intangible.

(7) Treatment of amortizable section 197 intangibles as depreciable property.

(i) In general.

(ii) Exceptions and limitations.

(A) Unstated interest and original issue discount rules.

(B) Treatment of other parties to transaction.

(h) Anti-churning rules.

(1) Conversions of existing goodwill, going concern value, and certain other section 197 intangibles.

(2) Amounts deductible under section 1253(d).

(3) Transition period.

(4) Exceptions.

(5) Special partnership provisions.

(i) Basis increases.

(ii) Curative and remedial allocations under section 704(c).

(6) Related person.

(i) In general.

(ii) Time for testing relationships.

(iii) De minimis rule.

(A) In general.

(B) Determination of beneficial ownership interest.

(7) Special rules for entities that owned or used property at any time during the transition period and that are no longer in existence.

(8) Special rules for section 338 deemed acquisitions.

(9) Exception to anti-churning rules where gain is recognized.

(i) In general.

(ii) Manner of making election. [Reserved]

(iii) Determination of highest marginal rate of tax.

(A) Noncorporate taxpayers.

(B) Corporations and tax-exempt entities.

(iv) Special rule for pass-through entities.

(v) Coordination with other provisions.

(A) In general.

(B) Section 1374.

(C) Procedural and administrative provisions.

(D) Installment method.

(10) Transactions subject to both anti-churning and nonrecognition rules.

(11) Anti-churning anti-abuse rule.

(i) [Reserved].

(j) General anti-abuse rule.

(k) Examples.

(l) Effective dates.

Par. 6. Section 1.197-2 is added to read as follows:

*§ 1.197-2 Amortization of goodwill and certain other intangibles.*

(a) *Overview*—(1) *In general*. 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, and paragraphs (d) and (e) of this section provide rules and definitions for determining whether a *section 197 intangible* is an amortizable section 197 intangible. The amortization deduction under section 197 is determined by amortizing adjusted basis ratably over a 15-year period under the rules of paragraph (f) of this section. Section 197 also includes various special rules pertaining to the disposition of amortizable section 197 intangibles, nonrecognition transactions, anti-churning rules, and anti-abuse rules. Rules relating to these provisions are contained in paragraphs (g), (h), and (j) of this section. Examples demonstrating the application of these provisions are contained in paragraph (k) of this section. The effective date of the rules in this section is contained in paragraph (l) of this section.

(2) *Section 167(f) property*. Section 167(f) prescribes rules for computing the depreciation deduction for certain property to which section 197 does not apply. See § 1.167(a)-14 for rules under section 167(f) and paragraphs (c)(4), (6), (7), (11), and (13) of this section for a description of the property subject to section 167(f).

(3) *Amounts otherwise deductible*. Except as otherwise provided in section 197(f)(3) and paragraphs (b)(11) and (f)(3) of this section, section 197 does not apply to amounts that would be currently deductible without regard to section 197.

(4) *Relationship to other Internal Revenue Code provisions*. Section 197 does not apply to any amount paid or incurred for a section 197 intangible if a deduction for the amount would be disallowed under any provision of the Internal Revenue Code other than section 263. (See, for example, section 162(k).)

(b) *Section 197 intangibles; in general*. Except as otherwise provided in paragraph (c) of this section, the term *section 197 intangible* means any property described in section 197(d)(1). The following rules and definitions provide guidance concerning property that is a section 197 intangible unless an exception applies:

(1) *Goodwill*. Section 197 intangibles include goodwill. Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.

(2) *Going concern value*. Section 197 intangibles include going concern value. Going concern value is the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership, but does not include any of the intangibles described in any other provision of this paragraph (b). It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

(3) *Workforce in place.* Section 197 intangibles include workforce in place. Workforce in place (sometimes referred to as agency force or assembled workforce) includes the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Thus, the amount paid or incurred for workforce in place includes, for example, any portion of the purchase price of an acquired trade or business attributable to the existence of a highly-skilled workforce, an existing employment contract (or contracts), or a relationship with employees or consultants (including, but not limited to, any key employee contract or relationship). Workforce in place does not include any covenant not to compete or other similar arrangement described in paragraph (b)(9) of this section.

(4) *Information base.* Section 197 intangibles include business books and records, operating systems, and any other information base, including lists or other information of current or prospective customers (regardless of the method of recording the information). Thus, the amount paid or incurred for these items includes, for example, any portion of the purchase price of an acquired trade or business attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems. Other examples include the cost of acquiring customer lists, subscription lists, insurance expirations, patient or client files, or lists of newspaper, magazine, radio, or television advertisers.

(5) *Know-how, etc.* Section 197 intangibles include any patent, copyright, formula, process, design, pattern, know-how, format, package design, computer software (as defined in paragraph (c)(4) of this section), or interest in a film, sound recording, video tape, book, or other similar property. (See, however, the exceptions in paragraph (c) of this section.)

(6) *Customer-based intangibles.* Section 197 intangibles include any customer-based intangible. A customer-based intangible is any composition of market, market share, or other value resulting from the future provision of goods or services pursuant to contractual or other relationships in the ordinary course of business with customers. Thus, the amount paid or incurred for

customer-based intangibles includes, for example, any portion of the purchase price of an acquired trade or business attributable to the existence of a customer base, a circulation base, an undeveloped market or market growth, insurance in force, the existence of a qualification to supply goods or services to a particular customer, a mortgage servicing contract (as defined in paragraph (c)(11) of this section), an investment management contract, or other relationship with customers involving the future provision of goods or services. (See, however, the exceptions in paragraph (c) of this section.) In addition, customer-based intangibles include the deposit base and any similar asset of a financial institution. Thus, the amount paid or incurred for customer-based intangibles also includes any portion of the purchase price of an acquired financial institution attributable to the value represented by existing checking accounts, savings accounts, escrow accounts, and other similar items of the financial institution. However, any portion of the purchase price of an acquired trade or business attributable to accounts receivable or other similar rights to income for goods or services provided to customers prior to the acquisition of a trade or business is not an amount paid or incurred for a customer-based intangible.

(7) *Supplier-based intangibles.* Section 197 intangibles include any supplier-based intangible. A supplier-based intangible is the value resulting from the future acquisition, pursuant to contractual or other relationships with suppliers in the ordinary course of business, of goods or services that will be sold or used by the taxpayer. Thus, the amount paid or incurred for supplier-based intangibles includes, for example, any portion of the purchase price of an acquired trade or business attributable to the existence of a favorable relationship with persons providing distribution services (such as favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts. The amount paid or incurred for supplier-based intangibles does not include any amount required to be paid for the goods or services themselves pursuant to the terms of the agreement or other relationship. In addition, see the exceptions in paragraph (c) of this section, including the exception in paragraph (c)(6) of this section for certain rights to

receive tangible property or services from another person.

(8) *Licenses, permits, and other rights granted by governmental units.* Section 197 intangibles include any license, permit, or other right granted by a governmental unit (including, for purposes of section 197, an agency or instrumentality thereof) even if the right is granted for an indefinite period or is reasonably expected to be renewed for an indefinite period. These rights include, for example, a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license. The issuance or renewal of a license, permit, or other right granted by a governmental unit is considered an acquisition of the license, permit, or other right. (See, however, the exceptions in paragraph (c) of this section, including the exceptions in paragraph (c)(3) of this section for an interest in land, in paragraph (c)(8) of this section for an interest under a lease of tangible property, and in paragraphs (c)(6) and (13) of this section for certain rights granted by a governmental unit. See paragraph (b)(10) of this section for the treatment of franchises.)

(9) *Covenants not to compete and other similar arrangements.* 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 or the provision of property or the use of property (other than property of the acquired trade or business) 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 or for the property or use of the property actually provided.

(10) *Franchises, trademarks, and trade names.* (i) Section 197 intangibles include any franchise, trademark, or trade name. The term *franchise* includes any agreement that provides one of the parties to the agreement with the right



to distribute, sell, or provide goods, services, or facilities, within a specified area. (See section 1253(b)(1).) The term includes distributorships or other similar contractual arrangements pursuant to which the transferee is permitted or licensed to operate or conduct a trade or business within a specific area. The term *trademark* includes any word, name, symbol, or device, or any combination thereof, adopted and used by a manufacturer or merchant to identify goods or services and distinguish them from those manufactured or sold by others. The term *trade name* includes any name used by a manufacturer or merchant 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. A license, permit, or other right granted by a governmental unit is a franchise if it otherwise meets the definition of a franchise. A trademark or trade name includes any trademark or trade name arising under statute or applicable common law, and any similar right granted by contract. The renewal of a franchise, trademark, or trade name is treated as an acquisition of the franchise, trademark, or trade name.

(ii) Notwithstanding the definitions provided in paragraph (b)(10)(i) of this section, any amount that is paid or incurred on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name and that is subject to section 1253(d)(1) is not included in the basis of a section 197 intangible. (See paragraph (g)(5) of this section.)

(11) *Contracts for the use of, and term interests in, other section 197 intangibles.* Section 197 intangibles include any right under a license, contract, or other arrangement providing for the use of property that would be a section 197 intangible under any provision of this paragraph (b) (including this paragraph (b)(11)) after giving effect to all of the exceptions provided in paragraph (c) of this section. Section 197 intangibles also include any term interest (whether outright or in trust) in such property.

(12) *Other similar items.* Section 197 intangibles include any other intangible property that is similar in all material respects to the property specifically described in section 197(d)(1)(C) and paragraphs (b)(3) through (7) of this section. (See paragraph (g)(4) of this section for special rules regarding certain reinsurance transactions.)

(c) *Section 197 intangibles; exceptions.* The term *section 197 intangible* does not include property described in section 197(e). The following rules and definitions provide guidance concerning property to which the exceptions apply:

(1) *Interests in a corporation, partnership, trust, or estate.* Section 197 intangibles do not include an interest in a corporation, partnership, trust, or estate. Thus, for example, amortization under section 197 is not available for the cost of acquiring stock, partnership interests, or interests in a trust or estate, whether or not the interests are regularly traded on an established market. (See paragraph (g)(3) of this section for special rules applicable to property of a partnership when a section 754 election is in effect for the partnership.)

(2) *Interests under certain financial contracts.* Section 197 intangibles do not include an interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract, whether or not the interest is regularly traded on an established market. However, this exception does not apply to an interest under a mortgage servicing contract, credit card servicing contract, or other contract to service another person's indebtedness, or an interest under an assumption reinsurance contract. (See paragraph (g)(4) of this section for the treatment of assumption reinsurance contracts. See paragraph (c)(11) of this section and § 1.167(a)-14(d) for the treatment of mortgage servicing rights.)

(3) *Interests in land.* Section 197 intangibles do not include any interest in land. For this purpose, an interest in land includes a fee interest, life estate, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right, such as a farm allotment, quota for farm commodities, or crop acreage base. An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement.

(4) *Certain computer software—(i) In general.* Section 197 intangibles do not include any interest in computer software that is (or has been) readily available to the general public on similar terms, is subject to a nonexclusive li-

cence, and has not been substantially modified for the user. Computer software will not be considered to have been substantially modified if its cost does not exceed the greater of 125 percent of the price at which the unmodified version of the software is readily available to the general public or \$2,000. For the purpose of determining whether computer software has been substantially modified—

(A) Integrated programs acquired in a package from a single source are treated as a single computer program; and

(B) Any cost incurred to install the computer software is not treated as a cost of the software.

(ii) *Separately acquired software.* Section 197 intangibles do not include an interest in computer software that is not acquired as part of a purchase of a trade or business within the meaning of paragraph (e) of this section.

(iii) *Other exceptions.* Neither section 197 nor section 167(f) apply in the following cases:

(A) Any amount of the cost of an interest in computer software that is included, without being separately stated, in the cost of the hardware or other tangible property will be treated as part of the cost of the hardware or other tangible property.

(B) Any amount of the cost of an interest in computer software that would be deductible under any provision other than section 167(f) or 197 may be deducted and is not required to be capitalized.

(iv) *Computer software defined.* For purposes of this section, computer software is any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer (as defined in section 168(i)(2)(B)(ii)) to perform a desired function or set of functions, and the documentation required to describe and maintain those programs. It includes all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs as well as application programs, are included. Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software. Such incidental and

ancillary rights are not included in the definition of trademark or trade name under paragraph (b)(10)(i) of this section. For example, a trademark or trade name that is ancillary to the ownership or use of a specific computer software program in the taxpayer's trade or business and is not acquired for the purpose of marketing the computer software is included in the definition of computer software and is not included in the definition of trademark or trade name. Computer software does not include any data or information base described in paragraph (b)(4) of this section unless the data base or item is in the public domain and is incidental to a computer program. For this purpose, a copyrighted or proprietary data or information base is treated as in the public domain if its availability through the computer program does not contribute significantly to the cost of the program. For example, if a word-processing program includes a dictionary feature used to spell-check a document or any portion thereof, the entire program (including the dictionary feature) is computer software regardless of the form in which the feature is maintained or stored.

(v) *Readily available to the general public.* Computer software will be treated as readily available to the general public if the software may be obtained on substantially the same terms by a significant number of persons that would reasonably be expected to use the software. The requirements of this paragraph (c)(4)(v) can be met even though the software is not available through a system of retail distribution.

(5) *Certain interests in films, sound recordings, video tapes, books, or other similar property.* Section 197 intangibles do not include any interest (including an interest as a licensee) in a film, sound recording, video tape, book, or other similar property (such as the right to broadcast or transmit a live event) if the interest is not acquired as part of a purchase of a trade or business. A film, sound recording, video tape, book, or other similar property includes any incidental and ancillary rights (such as a trademark or trade name) that are necessary to effect the acquisition of title to, the ownership of, or the right to use the property and are used only in connection with that property. Such incidental and ancillary rights are not included in the definition of trademark or trade name under paragraph (b)(10)(i) of this section. For purposes of this paragraph (c)(5), computer software (as defined in

paragraph (c)(4)(iv) of this section) is not treated as other property similar to a film, sound recording, video tape, or book. (See section 167 for amortization of excluded intangible property or interests.)

(6) *Certain rights to receive tangible property or services.* Section 197 intangibles do not include any right to receive tangible property or services under a contract or from a governmental unit if the right is not acquired as part of a purchase of a trade or business. Any right that is described in the preceding sentence is not treated as a section 197 intangible even though the right is also described in section 197(d)(1)(D) and paragraph (b)(8) of this section (relating to certain governmental licenses, permits, and other rights) and even though the right fails to meet one or more of the requirements of paragraph (c)(13) of this section (relating to certain rights of fixed duration or amount). (See § 1.167(a)-14(c)(1) and (3) for applicable rules.)

(7) *Certain interests in patents or copyrights.* Section 197 intangibles do not include any interest (including an interest as a licensee) in a patent, patent application, or copyright that is not acquired as part of a purchase of a trade or business. (See § 1.167(a)-14(c)(4) for applicable rules.)

(8) *Interests under leases of tangible property—(i) Interest as a lessor.* Section 197 intangibles do not include any interest as a lessor under an existing lease or sublease of tangible real or personal property. In addition, the cost of acquiring an interest as a lessor in connection with the acquisition of tangible property is taken into account as part of the cost of the tangible property. For example, if a taxpayer acquires a shopping center that is leased to tenants operating retail stores, any portion of the purchase price attributable to favorable lease terms is taken into account as part of the basis of the shopping center and in determining the depreciation deduction allowed with respect to the shopping center. (See section 167(c)(2).)

(ii) *Interest as a lessee.* Section 197 intangibles do not include any interest as a lessee under an existing lease of tangible real or personal property. For this purpose, an airline lease of an airport passenger or cargo gate is a lease of tangible property. The cost of acquiring such an interest is taken into account under section 178 and § 1.162-11(a). If an interest as a lessee under a lease of tangible property is acquired in

a transaction with any other intangible property, a portion of the total purchase price may be allocable to the interest as a lessee based on all of the relevant facts and circumstances.

(9) *Interests under indebtedness—(i) In general.* Section 197 intangibles do not include any interest (whether as a creditor or debtor) under an indebtedness in existence when the interest was acquired. Thus, for example, the value attributable to the assumption of an indebtedness with a below-market interest rate is not amortizable under section 197. In addition, the premium paid for acquiring a debt instrument with an above-market interest rate is not amortizable under section 197. See section 171 for rules concerning the treatment of amortizable bond premium.

(ii) *Exceptions.* For purposes of this paragraph (c)(9), an interest under an existing indebtedness does not include the deposit base (and other similar items) of a financial institution. An interest under an existing indebtedness includes mortgage servicing rights, however, to the extent the rights are stripped coupons under section 1286.

(10) *Professional sports franchises.* Section 197 intangibles do not include any franchise to engage in professional baseball, basketball, football, or any other professional sport, and any item (even though otherwise qualifying as a section 197 intangible) acquired in connection with such a franchise.

(11) *Mortgage servicing rights.* Section 197 intangibles do not include any right described in section 197(e)(7) (concerning rights to service indebtedness secured by residential real property that are not acquired as part of a purchase of a trade or business). (See § 1.167(a)-14(d) for applicable rules.)

(12) *Certain transaction costs.* Section 197 intangibles do not include any fees for professional services and any transaction costs incurred by parties to a transaction in which all or any portion of the gain or loss is not recognized under part III of subchapter C of the Internal Revenue Code.

(13) *Rights of fixed duration or amount.* (i) Section 197 intangibles do not include any right under a contract or any license, permit, or other right granted by a governmental unit if the right—

(A) Is acquired in the ordinary course of business and not as part of a purchase of a trade or business;

(B) Is not described in sections 197(d)(1)(A), (B), (C)(ii), (iv), or (vi), (E), or (F); and

(C) Either—

(I) Has a fixed duration of less than 15 years; or

(2) Is fixed as to amount and the adjusted basis thereof is properly recoverable (without regard to this section) under a method similar to the unit-of-production method.

(ii) See § 1.167(a)–14(c)(2) and (3) for applicable rules.

(d) *Amortizable section 197 intangibles*—(1) *Definition*. Except as otherwise provided in this paragraph (d), the term *amortizable section 197 intangible* means any section 197 intangible acquired after August 10, 1993 (or after July 25, 1991, if a valid retroactive election under § 1.197–1T has been made), and held in connection with the conduct of a trade or business or an activity described in section 212.

(2) *Exception for self-created intangibles*—(i) *In general*. Except as provided in paragraph (d)(2)(iii) of this section, amortizable section 197 intangibles do not include any section 197 intangible created by the taxpayer (a self-created intangible).

(ii) *Created by the taxpayer*—(A) *Defined*. 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 creation, production, development, or improvement occurs. For example, a technological process developed specifically for a taxpayer under an arrangement with another person pursuant to which the taxpayer retains all rights to the process is created by the taxpayer.

(B) *Contracts for the use of intangibles*. A section 197 intangible is not created by the taxpayer to the extent that it results from the entry into (or renewal of) a contract for the use of an existing section 197 intangible. Thus, for example, the exception for self-created intangibles does not apply to legal and other professional fees incurred by a licensee in connection with the entry into (or renewal of) a contract for the use of know-how or similar property.

(C) *Improvements and modifications*. If an existing section 197 intangible is improved or otherwise modified by the

taxpayer or by another person under a contract with the taxpayer, the existing intangible and the improvements or other modifications are treated as separate section 197 intangibles for purposes of this paragraph (d).

(iii) *Exceptions*. (A) The exception for self-created intangibles does not apply to any section 197 intangible described in section 197(d)(1)(D) (relating to licenses, permits or other rights granted by a governmental unit), 197(d)(1)(E) (relating to covenants not to compete), or 197(d)(1)(F) (relating to franchises, trademarks, and trade names). Thus, for example, capitalized costs incurred in the development, registration, or defense of a trademark or trade name do not qualify for the exception and are amortized over 15 years under section 197.

(B) The exception for self-created intangibles does not apply to any section 197 intangible created in connection with the purchase of a trade or business (as defined in paragraph (e) of this section).

(C) If a taxpayer disposes of a self-created intangible and subsequently reacquires the intangible in an acquisition described in paragraph (h)(4)(ii) of this section, the exception for self-created intangibles does not apply to the reacquired intangible.

(3) *Exception for property subject to anti-churning rules*. Amortizable section 197 intangibles do not include any property to which the anti-churning rules of section 197(f)(9) and paragraph (h) of this section apply.

(e) *Purchase of a trade or business*. Several of the exceptions in section 197 apply only to property that is not acquired in (or created in connection with) a transaction or series of related transactions involving the acquisition of assets constituting a trade or business or a substantial portion thereof. Property acquired in (or created in connection with) such a transaction or series of related transactions is referred to in this section as property acquired as part of (or created in connection with) a purchase of a trade or business. For purposes of section 197 and this section, the applicability of the limitation is determined under the following rules:

(1) *Goodwill or going concern value*. A group of assets constitutes a trade or business or a substantial portion thereof if their use would constitute a trade or business under section 1060 (that is, if goodwill or going concern value could under any circumstances attach to the

assets). See § 1.1060–1T(b)(2). For this purpose, all the facts and circumstances, including any employee relationships that continue (or covenants not to compete that are entered into) as part of the transfer of the assets, are taken into account in determining whether goodwill or going concern value could attach to the assets.

(2) *Customer-based intangibles*. Whether or not a group of assets is otherwise described in paragraph (e)(1) of this section, a group of assets constitutes a trade or business or a substantial portion thereof if the assets include any customer-based intangibles (as defined in paragraph (b)(6) of this section) or are acquired in a transaction or series of related transactions that involve the creation of any customer-based intangibles.

(3) *Franchise, trademark, or trade name*—(i) *In general*. The acquisition of a franchise, trademark, or trade name constitutes the acquisition of a trade or business or a substantial portion thereof.

(ii) *Exceptions*. For purposes of this paragraph (e)(3)—

(A) A trademark or trade name is disregarded if it is included in computer software under paragraph (c)(4) of this section or in an interest in a film, sound recording, video tape, book, or other similar property under paragraph (c)(5) of this section; and

(B) A franchise, trademark, or trade name is disregarded if its value is nominal or the taxpayer irrevocably disposes of it immediately after its acquisition.

(4) *Acquisitions to be included*. The assets acquired in a transaction (or series of related transactions) include only assets (including a beneficial or other indirect interest in assets where the interest is of a type described in paragraph (c)(1) of this section) acquired by the taxpayer and persons related to the taxpayer from another person and persons related to that other person. For purposes of this paragraph (e)(4), persons are related only if their relationship is described in section 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of section 41(f)(1).

(5) *Substantial portion*. The determination of whether acquired assets constitute a substantial portion of a trade or business is to be based on all of the facts and circumstances, including the nature and the amount of the assets acquired as well as the nature and amount of the assets retained by the transferor. The value of the assets ac-

quired relative to the value of the assets retained by the transferor is not determinative of whether the acquired assets constitute a substantial portion of a trade or business.

(6) *Deemed asset purchases under section 338.* A qualified stock purchase that is treated as a purchase of assets under section 338 shall be treated as a transaction involving the acquisition of assets constituting a trade or business only if the direct acquisition of the assets of the corporation would have been treated as the acquisition of assets constituting a trade or business.

(f) *Computation of amortization deduction—(1) In general.* Except as provided in paragraph (f)(2) of this section, the amortization deduction allowable under section 197(a) is computed as follows:

(i) The adjusted basis (for purposes of determining gain) of an amortizable section 197 intangible is amortized ratably over the 15-year period beginning on the later of—

(A) The first day of the month in which the property is acquired; or

(B) In the case of property held in connection with the conduct of a trade or business, the first day of the month in which the active conduct of the trade or business begins.

(ii) Except as otherwise provided in this section, adjusted basis is determined under section 1011 and salvage value is disregarded.

(iii) Property is not eligible for amortization in the month of disposition.

(iv) The amortization deduction for a short taxable year is based on the number of months in the short taxable year.

(2) *Treatment of contingent amounts—(i) Amounts added to basis during 15-year period.* Any amount that is properly included in the basis of an amortizable section 197 intangible after the first month of the 15-year period described in paragraph (f)(1)(i) of this section and before the expiration of this period is amortized ratably over the remainder of the 15-year period. For this purpose, the remainder of the 15-year period begins on the first day of the month in which the basis increase occurs. Any reasonable convention may be used to determine the month in which the basis increase incurs, provided that the method selected is used consistently for all amortizable section 197 intangibles acquired in the same transaction (or series of related transactions) and that it does not result in any amount being added to basis earlier than the

midpoint of the period (for example, annual, semi-annual, or quarterly) selected.

(ii) *Amounts becoming fixed after expiration of 15-year period.* Any amount that is not properly included in the basis of an amortizable section 197 intangible until after the expiration of the 15-year period described in paragraph (f)(1)(i) of this section is amortized in full immediately upon the inclusion of the amount in the basis of the intangible.

(iii) *Time for including amounts in basis.* See § 1.461-1(a)(1) for rules governing the time at which an amount may be taken into account by a taxpayer using the cash receipts and disbursements method, and § 1.461-1(a)(2) for rules governing the time at which a liability is incurred and generally taken into account (for example, by treating the amount of the liability as a capital expenditure) by an accrual basis taxpayer.

(3) *Determination of amounts chargeable to capital account in certain cases—(i) Covenants not to compete, rights granted by governmental units, and contracts for the use of section 197 intangibles—(A) In general.* In the case of a covenant not to compete or other similar arrangement described in paragraph (b)(9) of this section, any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof described in paragraph (b)(8) of this section, or a contract for the use of a section 197 intangible described in paragraph (b)(11) of this section, the amount chargeable to capital account includes all amounts required to be paid pursuant to the agreement or right, whether or not any amount would be deductible under section 162 if the agreement or right were not a section 197 intangible.

(B) *Time for taking amounts into account.* For purposes of this paragraph (f)(3), in applying the provisions of §§ 1.461-1(a)(1) (in the case of a taxpayer using the cash receipts and disbursements method of accounting) and § 1.461-1(a)(2) (in the case of a taxpayer using an accrual method of accounting), all amounts required to be paid under an agreement described in paragraph (b)(9) or (11) of this section shall be treated as amounts payable under the terms of a debt instrument issued in exchange for property. Contingent payments made under an agreement described in paragraph (b)(9) or (11) of

this section will be included in adjusted basis under the rules of paragraph (f)(2) of this section.

(ii) *Franchises, trademarks, or trade names and licenses, permits, and other rights granted by governmental units.* The costs paid or incurred for the renewal of a franchise, trademark, or trade name or any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof are amortized over the 15-year period that begins with the month of renewal. Any costs paid or incurred for the issuance, or earlier renewal, continue to be taken into account over the remaining portion of the amortization period that began at the time of the issuance, or earlier renewal. Any amount paid or incurred for the protection, expansion, or defense of a trademark or trade name and chargeable to capital account is treated as an amount paid or incurred for a renewal.

(iii) *Certain reinsurance transactions.* See paragraph (g)(4)(ii) of this section for special rules regarding the adjusted basis of an insurance contract acquired through an assumption reinsurance transaction.

(4) *Transactions subject to section 338 or 1060.* In the case of a section 197 intangible deemed to have been acquired as the result of a qualified stock purchase within the meaning of section 338(d)(3), the basis shall be determined pursuant to section 338(b)(5) and the regulations thereunder. In the case of a section 197 intangible acquired in an applicable asset acquisition within the meaning of section 1060(c), the basis shall be determined pursuant to section 1060(a) and the regulations thereunder.

(g) *Special rules—(1) Treatment of certain dispositions—(i) Loss disallowance rules—(A) In general.* No loss is recognized on the disposition of an amortizable section 197 intangible acquired in a transaction or series of related transactions in which the taxpayer acquired other amortizable section 197 intangibles if, after the disposition, the taxpayer retains any of the other amortizable section 197 intangibles, or the right to use, or an interest in, any of the other amortizable section 197 intangibles (the retained intangibles). Except as otherwise provided in paragraph (g)(1)(iv)(B) of this section, the adjusted basis of each of the retained intangibles is increased by the product of the loss that is not recognized solely by reason of this rule and a fraction, the numerator

of which is the adjusted basis of the retained intangible on the date of the disposition and the denominator of which is the total adjusted bases of all the retained intangibles on that date. 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), and the abandoned or worthless intangible is disregarded (that is, it is not treated as a retained intangible) for purposes of applying this paragraph (g)(1) to the subsequent disposition of any other amortizable section 197 intangible.

(B) *Certain nonrecognition transfers.* The loss disallowance rule in paragraph (g)(1)(i)(A) of this section also applies when a taxpayer transfers an amortizable section 197 intangible from an acquired trade or business in a transaction in which the intangible is transferred-basis property and, after the transfer, retains other amortizable section 197 intangibles from the trade or business. Thus, for example, the transfer of an amortizable section 197 intangible to a corporation in exchange for stock in the corporation in a transaction described in section 351, or to a partnership in exchange for an interest in the partnership in a transaction described in section 721, when other amortizable section 197 intangibles acquired in the same transaction are retained, followed by a sale of the stock or partnership interest received, will not avoid the application of the loss disallowance provision to the extent the adjusted basis of the transferred intangible at the time of the sale exceeds its fair market value at that time.

(ii) *Separately acquired property.* Paragraph (g)(1)(i) of this section does not apply to an amortizable section 197 intangible that is not acquired in a transaction or series of related transactions in which the taxpayer acquires other amortizable section 197 intangibles (a separately acquired intangible). Consequently, a loss may be recognized upon the disposition of a separately acquired section 197 intangible. However, the termination or worthlessness of only a portion of an amortizable section 197 intangible is not the disposition of a separately acquired intangible. For example, neither the loss of several customers from an acquired customer list, the termination of several mortgages (not qualifying for the exception set forth in paragraph (c)(11) of this sec-

tion) from an acquired mortgage pool, nor the worthlessness of only some information from an acquired data base constitutes the disposition of a separately acquired intangible.

(iii) *Disposition of a covenant not to compete.* If a covenant not to compete or any other arrangement having substantially the same effect is entered into in connection with the direct or indirect acquisition of an interest in a trade or business, the disposition or worthlessness of the covenant or other arrangement will not be considered to occur until the disposition or worthlessness of all interests in that trade or business. For example, a covenant not to compete entered into in connection with the purchase of stock continues to be amortized on a 15-year straight-line basis (even after the covenant expires or becomes worthless) unless all the trades or businesses in which an interest was acquired through the stock purchase (or all the purchaser's interests in those trades or businesses) also are disposed of or become worthless.

(iv) *Taxpayers under common control—(A) In general.* Except as provided in paragraph (g)(1)(iv)(B) of this section, all persons that would be treated as a single taxpayer under section 41(f)(1) are treated as a single taxpayer under this paragraph (g)(1). Thus, for example, a loss is not recognized on the disposition of an amortizable section 197 intangible by a member of a controlled group of corporations (as defined in section 41(f)(5)) if, after the disposition, another member retains other amortizable section 197 intangibles acquired in the same transaction as the amortizable section 197 intangible that has been disposed of.

(B) *Treatment of disallowed loss.* If retained intangibles are held by a person other than the person incurring the disallowed loss, only the adjusted basis of intangibles retained by the person incurring the disallowed loss is increased, and only the adjusted basis of those intangibles is included in the denominator of the fraction described in paragraph (g)(1)(i)(A) of this section. If none of the retained intangibles are held by the person incurring the disallowed loss, the loss is allowed ratably, as a deduction under section 197, over the remainder of the period during which the intangible giving rise to the loss would have been amortizable, except that any remaining disallowed loss is allowed in full on the first date on

which all other retained intangibles have been disposed of or become worthless.

(2) *Treatment of certain nonrecognition and exchange transactions—(i) In general—(A) Transfer disregarded.* Except as otherwise provided in paragraph (h) of this section, if a section 197 intangible is transferred in a transaction described in paragraph (g)(2)(ii) of this section, the transfer is disregarded in determining—

(1) Whether, with respect to so much of the intangible's basis in the hands of the transferee as does not exceed its basis in the hands of the transferor, the intangible is an amortizable section 197 intangible; and

(2) The amount of the deduction under section 197 with respect to such basis.

(B) *Application of general rule.* If the intangible described in paragraph (g)(2)(i)(A) of this section was an amortizable section 197 intangible in the hands of the transferor, the transferee will continue to amortize its adjusted basis, to the extent it does not exceed the transferor's adjusted basis, ratably over the remainder of the transferor's 15-year amortization period. If the intangible was not an amortizable section 197 intangible in the hands of the transferor, the transferee's adjusted basis, to the extent it does not exceed the transferor's adjusted basis, cannot be amortized under section 197. In either event, the intangible is treated, with respect to so much of its adjusted basis in the hands of the transferee as exceeds its adjusted basis in the hands of the transferor, in the same manner for purposes of section 197 as an intangible acquired from the transferor in a transaction that is not described in paragraph (g)(2)(ii) of this section. The rules of this paragraph (g)(2)(i) also apply to any subsequent transfers of the intangible in a transaction described in paragraph (g)(2)(ii) of this section.

(ii) *Transactions covered.* The transactions described in this paragraph (g)(2)(ii) are—

(A) Any transaction described in section 332, 351, 361, 721, or 731; and

(B) Any transaction between corporations that are members of the same consolidated group immediately after the transaction.

(iii) *Certain exchanged-basis property.* This paragraph (g)(2)(iii) applies to property that is acquired in a transaction subject to section 1031 or 1033 and is permitted to be acquired without recognition of gain (replacement property).

Except as otherwise provided in paragraph (h) of this section, replacement property is treated as if it were the property by reference to which its basis is determined (the predecessor property) in determining whether, with respect to so much of its basis as does not exceed the basis of the predecessor property, the replacement property is an amortizable section 197 intangible and the amortization period under section 197 with respect to such basis. Thus, if the predecessor property was an amortizable section 197 intangible, the taxpayer will amortize the adjusted basis of the replacement property, to the extent it does not exceed the adjusted basis of the predecessor property, ratably over the remainder of the 15-year amortization period for the predecessor property. If the predecessor property was not an amortizable section 197 intangible, the adjusted basis of the replacement property, to the extent it does not exceed the adjusted basis of the predecessor property, may not be amortized under section 197. In either event, the replacement property is treated, with respect to so much of its adjusted basis as exceeds the adjusted basis of the predecessor property, in the same manner for purposes of section 197 as property acquired from the transferee in a transaction that is not subject to section 1031 or 1033. (See paragraph (h) of this section for the application of the anti-churning rules.)

(iv) *Transfers under section 708(b)-(1)*—(A) *In general.* Paragraph (g)(2)(i) of this section applies to transfers of section 197 intangibles that occur or are deemed to occur by reason of the termination of a partnership under section 708(b)(1).

(B) *Termination by sale or exchange of interest.* In applying paragraph (g)(2)(i) of this section to a partnership that is terminated pursuant to section 708(b)(1)(B) (relating to a sale or exchange of an interest), the terminated partnership is treated as the transferor and the new partnership is treated as the transferee with respect to any section 197 intangible held by the terminated partnership immediately preceding the termination. (See paragraph (g)(3) of this section for the treatment of increases in the basis of property of the terminated partnership under section 743(b).)

(C) *Other terminations.* In applying paragraph (g)(2)(i) of this section to a partnership that is terminated pursuant to section 708(b)(1)(A) (relating to ces-

sation of activities by a partnership), the terminated partnership is treated as the transferor and the distributee partner is treated as the transferee with respect to any section 197 intangible held by the terminated partnership immediately preceding the termination.

(D) *Anti-churning rules.* See paragraph (h) of this section for the application of the anti-churning rules.

(v) *Distributions to which section 732(d) applies.* Paragraph (g)(2)(i) of this section applies to a distribution of a section 197 intangible to which section 732(d) (relating to special partnership basis to transferee) applies. For purposes of section 197, any increase in the basis of the distributed intangible under section 732(d) is taken into account by a partner as if the increased portion were attributable to the partner's acquisition of the underlying partnership property on the date of distribution from the transferor of the partnership interest or the deceased partner, as the case may be. For purposes of the effective date and anti-churning rules (paragraphs (d)(1) and (h) of this section), the intangible is treated as having been acquired by the transferee partner at the time of the transfer of the partnership interest described in section 732(d). For purposes of determining the amortization period under section 197 with respect to any increased basis, however, the intangible is treated as having been acquired by the transferee partner at the time of the distribution described in section 732(a). (See paragraph (h) of this section for the application of the anti-churning rules.)

(vi) *Curative and remedial allocations under section 704(c).* For purposes of paragraph (g)(2)(i) of this section, if a section 197 intangible is transferred to a partnership in a transaction described in section 721, the basis of the intangible in the hands of the transferor includes the amount of any curative or remedial allocations of amortization that are made to a noncontributing partner with respect to the contributed intangible under the curative or remedial methods for making allocations under section 704(c). Thus, for example, if a contributed intangible is not an amortizable section 197 intangible in the hands of the transferor, any remedial allocations of amortization made to a noncontributing partner with respect to the intangible are not amortizable under section 197. See § 1.704-3(c) and (d) for a description of the curative and remedial methods.

(3) *Application of section 754 to acquisitions of an interest in an intangible held through a partnership.* Any increase in the basis of partnership property under section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property) or section 743(b) (relating to the optional adjustment to the basis of partnership property) is taken into account under section 197 by a partner as if the increased portion of the basis were attributable to the partner's acquisition of the underlying partnership property and as if the property were acquired from the distributee partner on the date of the distribution (in the case of a basis increase under section 734(b)) or from the transferor of the partnership interest on the date of the transfer (in the case of a basis increase under section 743(b)). (See paragraph (h) of this section for the application of the anti-churning rules.)

(4) *Treatment of certain reinsurance transactions*—(i) *In general.* Section 197 applies to any insurance contract acquired from another person through an assumption reinsurance transaction. For purposes of section 197, an assumption reinsurance transaction is—

(A) Any arrangement in which one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company); and

(B) Any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338.

(ii) *Determination of adjusted basis*—(A) *Acquisitions (other than under section 338) of specified insurance contracts.* The amount taken into account for purposes of section 197 as the adjusted basis of specified insurance contracts (as defined in section 848(e)(1)) acquired in an assumption reinsurance transaction that is not described in paragraph (g)(4)(i)(B) of this section is equal to the excess of—

(1) The amount paid or incurred (or treated as having been paid or incurred) by the reinsurer for the purchase of the contracts (as determined under § 1.817-4(d)(2)); over

(2) The amount of the specified policy acquisition expenses that are attributable to the reinsurer's net positive consideration for the reinsurance agreement (as determined under § 1.848-2(f)(3)).

(B) *Other acquisitions.* [Reserved]

(5) *Amounts paid or incurred for a franchise, trademark, or trade name.* If an amount to which section 1253(d) (relating to the transfer, sale, or other disposition of a franchise, trademark, or trade name) applies is described in section 1253(d)(1)(B) (relating to contingent serial payments), the amount is deductible under section 1253(d)(1) and is not included in the adjusted basis of the intangible for purposes of section 197. Any other amount, whether fixed or contingent, to which section 1253(d) applies is chargeable to capital account under section 1253(d)(2) and is amortizable only under section 197.

(6) *Amounts properly taken into account in determining the cost of property that is not a section 197 intangible.* Section 197 does not apply to an amount that is properly taken into account in determining the cost of property that is not a section 197 intangible. The entire cost of acquiring the other property is included in its basis and recovered under other applicable Internal Revenue Code provisions.

(7) *Treatment of amortizable section 197 intangibles as depreciable property—(i) In general.* An amortizable section 197 intangible is treated as property of a character subject to the allowance for depreciation under section 167. Thus, for example, an amortizable section 197 intangible is not a capital asset for purposes of section 1221, but if held for more than one year, it generally qualifies under section 1231 as property used in a trade or business. Also, an amortizable section 197 intangible is section 1245 property and section 1239 applies to any gain recognized upon its sale or exchange between related persons (as defined in section 1239(b)).

(ii) *Exceptions and limitations—(A) Unstated interest and original issue discount rules.* In the case of the acquisition of any amortizable section 197 intangible in a transaction that would not be treated as the sale or exchange of property by the person from which the intangible was acquired, paragraph (g)(7)(i) of this section shall not apply (and the amortizable section 197 intangible shall not be treated as property) for purposes of—

(1) Section 483(c) (relating to payments on account of the sale or exchange of property); and

(2) Section 1274(c) (relating to debt instruments given in consideration for the sale or exchange of property).

(B) *Treatment of other parties to transaction.* No person shall be treated

as having sold, exchanged, or otherwise disposed of property in a transaction for purposes of any provision of the Internal Revenue Code solely by reason of the application of paragraph (g)(7)(i) of this section to any other party to the transaction.

(h) *Anti-churning rules—(1) Conversions of existing goodwill, going concern value, and certain other section 197 intangibles.* Except as otherwise provided in this paragraph (h), goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable prior to the enactment of section 197 may not be amortized as an amortizable section 197 intangible if the section 197 intangible is acquired by a taxpayer after August 10, 1993 (or after July 25, 1991, if a valid retroactive election pursuant to § 1.197-1T has been made) and either—

(i) The taxpayer or a related person held or used the intangible or an interest therein at any time during the transition period;

(ii) The taxpayer acquired the intangible from a person that held the intangible at any time during the transition period and, as part of the transaction, the user of the intangible does not change; or

(iii) The taxpayer grants the right to use the intangible to a person (or a person related to that person) that held or used the intangible at any time during the transition period.

(2) *Amounts deductible under section 1253(d).* For purposes of paragraph (h)(1) of this section, deductions allowable under section 1253(d)(2) or deductions allowable pursuant to an election under section 1253(d)(3) (in either case as in effect prior to the enactment of section 197) are treated as deductions allowable for amortization.

(3) *Transition period.* For purposes of this paragraph (h), the transition period begins on July 25, 1991, and ends on August 10, 1993, except that for taxpayers that made a valid retroactive election pursuant to § 1.197-1T, the transition period is July 25, 1991.

(4) *Exceptions.* The anti-churning rules of this paragraph (h) do not apply to—

(i) The acquisition of an intangible by a taxpayer if the basis of the intangible is determined under section 1014(a); or

(ii) The acquisition of an intangible by a taxpayer that is an amortizable

section 197 intangible in the hands of the seller (or transferor), but only if the acquisition by the taxpayer or sale by the seller (or transfer by the transferor) was not part of a transaction or a series of related transactions in which the seller (or transferor) previously acquired the intangible or interest therein.

(5) *Special partnership provisions—(i) Basis increases.* In determining whether the anti-churning rules of this paragraph (h) apply to any increase in the basis of partnership property under section 732, 734, or 743, the determinations are made at the partner level and each partner is treated as having owned and used the partner's proportionate share of the partnership property. Thus, for example, the anti-churning rules do not apply to an increase in the basis of partnership property under section 743(b) that occurs upon the acquisition of an interest in a partnership that has made a section 754 election if the person acquiring the partnership interest either is not related to the person transferring the partnership interest or acquired the interest upon the death of the former partner. Similarly, the anti-churning rules do not apply to a continuing partner's proportionate share of an increase in the basis of partnership property under section 734(b) that occurs upon the distribution of property of a partnership that has made a section 754 election if the continuing partner is not related to the distributee partner.

(ii) *Curative and remedial allocations under section 704(c).* In determining whether the anti-churning rules of this paragraph (h) apply, any curative or remedial allocation of amortization made to a noncontributing partner under the curative or remedial methods for making allocations under section 704(c) is treated in the same manner as a noncurative or nonremedial allocation of amortization. Thus, for example, if the anti-churning rules would apply to a nonremedial allocation of amortization to a noncontributing partner, the anti-churning rules apply to any remedial allocation of amortization. See § 1.704-3(c) and (d) for a description of the curative and remedial methods.

(6) *Related person—(i) In general.* Except as otherwise provided in paragraph (h)(6)(iii) of this section, a person is related to another person for purposes of this paragraph (h) if—

(A) The person bears a relationship to that person that would be specified in section 267(b) (determined without regard to section 267(e)) and, by substituting

tion, section 267(f)(1), if those sections were amended by substituting 20 percent for 50 percent; or

(B) The person bears a relationship to that person that would be specified in section 707(b)(1) if that section was amended by substituting 20 percent for 50 percent; or

(C) The persons are engaged in trades or businesses under common control (within the meaning of section 41(f)(1)(A) and (B)).

(ii) *Time for testing relationships.* For purposes of this paragraph (h), a person is treated as related to another person if the relationship exists—

(A) In the case of a single transaction, immediately before or immediately after the acquisition of the intangible involved; or

(B) In the case of a series of related transactions, at any time during the period beginning immediately before the earliest acquisition and ending immediately after the last acquisition of any intangible acquired in the series of transactions.

(iii) *De minimis rule*—(A) *In general.* Two corporations shall not be treated as related persons for purposes of this paragraph (h)(6) if—

(1) The corporations would (but for the application of this paragraph (h)(6)(iii)) be treated as related persons solely by reason of substituting “more than 20 percent” for “more than 50 percent” in section 267(f)(1)(A); and

(2) The beneficial ownership interest of one corporation in the stock of the other corporation represents less than 10 percent of the total combined voting power of all classes of stock entitled to vote and less than 10 percent of the total value of the shares of all classes of stock outstanding.

(B) *Determination of beneficial ownership interest.* For purposes of this paragraph (h)(6)(iii), the beneficial ownership interest of one corporation in the stock of another corporation shall be determined under the principles of section 318(a), except that—

(1) In applying section 318(a)(2)(C), the 50 percent limitation contained therein shall not be applied; and

(2) Section 318(a)(3)(C) shall be applied by substituting “20 percent” for “50 percent”.

(7) *Special rules for entities that owned or used property at any time during the transition period and that are no longer in existence.* A corporation, partnership, or trust that owned or used property at any time during the transi-

tion period and that is no longer in existence is deemed to be in existence for purposes of determining whether the taxpayer that acquired the property is related to the corporation, partnership, or trust.

(8) *Special rules for section 338 deemed acquisitions.* In the case of a qualified stock purchase that is treated as a deemed sale and purchase of assets pursuant to section 338, the corporation that is treated as selling its assets as a result of an election thereunder (old target) is not considered related to the corporation that is treated as purchasing the assets (new target) if stock of old target meeting the requirements of section 1504(a)(2) is, or is deemed to have been, acquired by purchase after July 25, 1991. See § 1.338-2(d). Thus, for example, if a corporation (the purchasing corporation) makes a qualified stock purchase of the stock of another corporation (target) from unrelated third parties in July 1997, and a section 338 election is made by the purchasing corporation, the deemed asset purchase shall not be considered as an acquisition between related persons solely by virtue of the fact that old target and new target are treated as the same corporation for certain other purposes of the Code or that old target and new target are the same corporation under the laws of the state or other jurisdiction of its organization. However, the anti-churning rules of this paragraph (h) may nevertheless apply to a deemed asset purchase resulting from a section 338 election because old target and new target are otherwise treated as related parties within the meaning of paragraph (h)(6) of this section.

(9) *Exception to anti-churning rules where gain is recognized*—(i) *In general.* If a taxpayer would not be subject to paragraph (h) but for the substitution of 20 percent for 50 percent under paragraph (h)(6)(i)(A) of this section and the person (whether or not subject to Federal income tax) from which the taxpayer acquires the intangible elects to recognize gain on the disposition of the intangible and, notwithstanding any other provision of the Internal Revenue Code, agrees to pay an amount that, when added to any other Federal income tax, equals the gain on the disposition multiplied by the highest marginal rate of tax imposed by section 11 (for individuals, estates, or trusts) or 11 (for corporations), whichever is applicable, for the taxable year in which the gain is realized by the person from which the

taxpayer acquires the intangible, then the anti-churning rules described in this paragraph (h) only apply to the extent the taxpayer’s adjusted basis in the intangible exceeds the gain recognized.

(ii) *Manner of making election.* [Reserved]

(iii) *Determination of highest marginal rate of tax.* For the purpose of determining the highest marginal rate of tax applicable to the person from which the taxpayer acquires the intangible, the following rules shall apply:

(A) *Noncorporate taxpayers.* In the case of an individual, estate, or trust, the highest marginal rate of tax shall be the highest marginal rate of tax in effect under section 1, determined without regard to section 1(h).

(B) *Corporations and tax-exempt entities.* In the case of a corporation or an entity that is exempt from tax under section 501(a), the highest marginal rate of tax shall be the highest marginal rate of tax in effect under section 11, determined without regard to any rate that is added to the otherwise applicable rate in order to offset the effect of the graduated rate schedule.

(iv) *Special rule for pass-through entities.* In the case of a partnership or S corporation, the election under paragraph (h)(9)(i) of this section—

(A) Shall be made by the entity rather than by its owners or members; and

(B) Shall constitute an election by each of the owners or members of the entity (rather than the entity itself) to pay a tax, determined as provided in this paragraph (h)(9), on the portion of the gain properly allocable to each such owner or member.

(v) *Coordination with other provisions*—(A) *In general.* For purposes of applying any provision of chapter 1 or chapter 6 of the Code other than section 197(f)(9)(B), both the amount of gain subject to the tax determined under paragraph (h)(9)(i) of this section and the amount of the tax shall be disregarded. Thus, for example, the amount of the gain shall not be reduced by any net operating loss deduction under section 172(a), any capital loss under section 1212, or any other similar loss or deduction. The amount of tax determined under paragraph (h)(9)(i) of this section shall not be reduced by any credit of the taxpayer. In computing the amount of any net operating loss, capital loss, or other similar loss or deduction, or any credit that may be carried to any taxable year, any gain recognized, and



any tax paid, under paragraph (h)(9)(i) of this section shall not be taken into account.

(B) *Section 1374.* No provision of paragraph (h)(9)(iv) of this section shall preclude the application of section 1374 (relating to a tax on certain built-in gains of S corporations) to any gain with respect to which the election described in paragraph (h)(9)(i) of this section is made. Neither paragraph (h)(9)(iv) nor paragraph (h)(9)(v)(A) of this section shall be treated as precluding a taxpayer from applying the provisions of section 1366(f)(2) (relating to treatment of the tax imposed by section 1374 as a loss sustained by the S corporation) in determining the amount of tax payable under paragraph (h)(9)(i) of this section.

(C) *Procedural and administrative provisions.* For purposes of subtitle F, the amount determined under paragraph (h)(9)(i) of this section is treated as a tax imposed by section 1 or 11, as appropriate.

(D) *Installment method.* The gain subject to the tax determined under paragraph (h)(9)(i) of this section may not be reported under the method described in section 453(a). Any such gain that would, but for the application of this paragraph (h)(9)(v)(D), be taken into account under section 453(a) shall be taken into account in the same manner as if an election under section 453(d) (relating to the election not to apply section 453(a)) had been made.

(10) *Transactions subject to both anti-churning and nonrecognition rules.* If a person acquires a section 197 intangible in a transaction described in paragraph (g)(2) of this section from a person in whose hands the intangible was an amortizable section 197 intangible, and as a result of the transaction, the person is or becomes related to any person described in paragraph (h)(1) of this section, the intangible ceases to be an amortizable section 197 intangible in the hands of the transferee unless the exception provided in paragraph (h)(4)(ii) of this section applies. If a person acquires a section 197 intangible in anticipation of becoming related to any person described in paragraph (h)(1) of this section, the intangible is not an amortizable section 197 intangible in the hands of the transferee.

(11) *Anti-churning anti-abuse rule.* Section 197 does not apply to any intangible acquired by a taxpayer if the taxpayer acquires the intangible in a transaction one of the principal purposes

of which is to avoid any of the anti-churning rules for intangibles described in paragraph (h)(1) of this section. Thus, for example, if section 197 intangibles are acquired in a transaction (or series of related transactions) in which options to acquire stock are issued to a party to the transaction, but the option is not treated as having been exercised for purposes of paragraph (h)(6) of this section, this paragraph (h)(11) may apply to the transaction.

(i) [Reserved].

(j) *General anti-abuse rule.* The rules in this section shall be interpreted and applied as necessary and appropriate to prevent avoidance of the purposes of section 197. If one of the principal purposes of a transaction is to achieve a tax result that is inconsistent with the purposes of section 197, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 197, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.

(k) *Examples.* The following examples illustrate the application of this section:

*Example 1. Computer software.* (i) X purchases all of the assets of an existing trade or business from Y. One of the assets acquired is all of Y's rights in certain computer software previously used by Y under the terms of a nonexclusive license from the software developer. The software was developed for use by manufacturers to maintain a comprehensive accounting system, including general and subsidiary ledgers, payroll, accounts receivable and payable, cash receipts and disbursements, fixed asset accounting, and inventory cost accounting and controls. The software was not substantially modified for use by Y within the meaning of paragraph (c)(4)(i) of this section and was acquired directly by Y from the developer. The developer does not maintain wholesale or retail outlets but markets the software directly to ultimate users. Y's license of the software is limited to an entity that is actively engaged in business as a manufacturer.

(ii) Notwithstanding these limitations, the software is considered to be readily available to the general public for purposes of paragraph (c)(4)(i) of this section. Accordingly, the software is not a section 197 intangible.

*Example 2. Governmental rights of fixed duration.* (i) City M operates a municipal water system. In order to induce X to locate a new manufacturing business in the city, M grants X the right to purchase water for 16 years at a specified price. X incurs legal fees and other costs for professional services in the amount of \$10x in connection with its efforts to obtain these rights.

(ii) The rights granted by M are described in section 197(e)(4)(B) and paragraph (c)(6) of this section and, thus, are not a section 197 intangible. This exclusion applies notwithstanding that the rights may not qualify for exclusion under section 197(e)(4)(D) and paragraph (c)(13) of this section or that they also may be described in section

197(d)(1)(D) and paragraph (b)(8) of this section and, as such, may not be treated as self-created intangibles eligible for exclusion under section 197(c)(2).

*Example 3. Advertising costs.* (i) Q manufactures and sells consumer products through a series of wholesalers and distributors. In order to increase sales of its product by encouraging consumer loyalty to its products and to enhance the value of the goodwill, trademarks, and trade names of the business, Q advertises its products to the consuming public. It regularly incurs costs to develop radio, television, and print advertisements. These costs generally consist of employee costs and amounts paid to independent advertising agencies. Q also incurs costs to run these advertisements in the various media for which they were developed. Except for the possible application of section 197, these costs would be ordinary and necessary expenses deductible under section 162.

(ii) The advertising costs are not subject to amortization under section 197 pursuant to paragraph (a)(3) of this section because they are otherwise deductible.

*Example 4. Covenant not to compete acquired in connection with stock redemption.* (i) R, a corporation, redeems all of its stock owned by A, an individual. R and A have no business relationships with each other except for the corporate-shareholder relationship. In connection with the stock redemption, R and A enter into an agreement containing a covenant not to compete. Under this agreement, A agrees that A will not compete with the business of R within a prescribed geographical territory for a period of three years after the date on which the stock redemption is completed. In exchange for this agreement, R pays A consideration in addition to the amount paid for the stock redeemed by R.

(ii) Because the agreement was entered into in connection with the reacquisition by R of its stock, section 162(k) provides that no deduction shall be allowed for any amount paid or incurred pursuant to the agreement. Accordingly, pursuant to paragraph (a)(4) of this section, section 197 does not apply to these amounts.

*Example 5. Substantial portion of trade or business.* (i) S owns and operates 100 restaurants in various locations. Each of these restaurants is operated using a well-established trade name made available to S under the terms of a franchise agreement with F. S determined to cease operating one of the franchised restaurants. Accordingly, S sold to B all of the assets that it had used exclusively in connection with the operation of its restaurant at that location. B agreed to extend an offer of employment to all of the employees at that location. B acquired no rights to the franchise or to any of the trademarks or trade names that had been used by S.

(ii) The transaction between B and S is a transaction involving the acquisition of assets constituting a trade or business or a substantial portion thereof within the meaning of paragraph (e) of this section, notwithstanding that B did not acquire a franchise from S or that the assets did not represent a substantial portion of the assets used by S in that trade or business.

*Example 6. Separate acquisition of franchise.* (i) S is a franchisor of retail outlets for specialty coffees. On July 1, 1997, G enters into an agreement with S pursuant to which G is permitted to acquire and operate a store using the S trademark and trade name at the location specified in the agreement. G agrees to pay S \$100,000 upon execution of the agreement and also agrees to pay, on a monthly basis throughout the term of the franchise, a specified percentage of gross sales

from the store. The agreement contains detailed specifications for the construction and operation of the business, but G is not required to purchase from S any of the materials necessary to construct the improvements at the location specified in the franchise agreement.

(ii) The franchise is a section 197 intangible within the meaning of paragraph (b)(10) of this section. The franchise does not qualify for the exclusion relating to self-created intangibles described in section 197(c)(2) and paragraph (d)(2) of this section because the franchise is described in section 197(d)(1)(F). In addition, because the acquisition of the franchise constitutes the acquisition of an interest in a trade or business or a substantial portion thereof, the franchise may not be excluded under section 197(e)(4). Thus, the franchise is an amortizable section 197 intangible, the basis of which must be recovered over a 15-year period. However, the amounts to be paid by G computed as a percentage of gross sales are not subject to the provisions of section 197 by reason of section 197(f)(4)(C) and paragraph (b)(10)(ii) of this section.

*Example 7. Acquisition and amortization of covenant not to compete.* (i) As part of the acquisition of a trade or business from C, B and C enter into an agreement containing a covenant not to compete. Under this agreement, C agrees that it will not compete with the business acquired by B within a prescribed geographical territory for a period of three years after the date on which the business is sold to B. In exchange for this agreement, B agrees to pay C \$90,000 per year for each year in the term of the agreement. The agreement further provides that, in the event of a breach by C of his obligations under the agreement, B may terminate the agreement, cease making any of the payments due thereafter, and pursue any other legal or equitable remedies available under applicable law. Assume that the amounts payable to C under the agreement represent the value of C's obligations to B pursuant to the covenant and that the present fair market value of B's rights under the agreement is \$225,000. The aggregate consideration paid for all assets acquired in the transaction other than the covenant exceeds the sum of the amount of Class I assets and the aggregate fair market value of all Class II and Class III assets and all Class IV assets other than the covenant.

(ii) Because the covenant is acquired in an applicable asset acquisition (within the meaning of section 1060(c)), the basis of B in the covenant cannot exceed its fair market value. See § 1.1060-1T(e)(1). Under section 197(f)(3) and paragraphs (f)(3)(i) and (4) of this section, the adjusted basis of B in the agreement, determined as of the date on which the agreement is entered into, is \$225,000. B's deduction for amortization with respect to the amounts to be paid under the agreement is \$1,250 per month, or \$15,000 per year, for each year in the 15-year period beginning on the date on which the agreement is entered into. The excess of the amounts payable pursuant to the agreement over the amount allocated to the covenant under § 1.1060-1T(e)(1), or \$45,000, is allocated to Class V assets.

*Example 8. Breach of covenant not to compete subsequent to acquisition.* (i) The facts are the same as in *Example 7*, except that at the end of the second year of the agreement, C breaches the agreement by competing against B. B and C enter into a settlement of all claims arising under the agreement and the subsequent breach by C by agreeing that B is not obligated to pay C the final installment of \$90,000.

(ii) Under paragraph (g)(1)(iii) of this section, the covenant is not treated as having been disposed of (or becoming worthless) because C has not disposed of all interests in the trade or business acquired in the same transaction as the covenant. The covenant is not a contingent income asset within the meaning of § 1.1060-1T(f)(4)(i). Accordingly, B must decrease the adjusted basis of any asset acquired from C by \$90,000 at the beginning of the third year of the agreement in the manner provided by § 1.1060-1T(f)(3)(i). To the extent that any decrease is allocated to an amortizable section 197 intangible, B must reduce the amount of its deduction for amortization under section 197 accordingly.

*Example 9. Loss disallowance rules involving related persons.* (i) Assume that X and Y are treated as a single taxpayer for purposes of paragraph (g)(1)(iv) of this section. In a single transaction, X and Y acquired from Z all of the assets used by Z in a trade or business. Z had operated this business at two locations, and X and Y each desired to acquire the assets used by Z at one of the locations. Three years after the acquisition, X sold all of the assets, including amortizable section 197 intangibles, to an unrelated purchaser at a loss of \$120,000.

(ii) Because X and Y are treated as a single taxpayer for purposes of the loss disallowance rules of section 197(f)(1) and paragraph (g)(1) of this section, X may not recognize its loss on the sale of the amortizable section 197 intangibles. Under paragraph (g)(1)(iv) of this section, X must amortize its disallowed loss under section 197, and Y may not increase its adjusted basis in its amortizable section 197 intangibles by the amount of the realized loss of X that is disallowed. X must amortize the disallowed loss over the remainder of the amortization period for the amortizable section 197 intangibles it sold. Accordingly, X must amortize the disallowed loss at the rate of \$10,000 per year (or \$833 per month) for each of the 12 years remaining in the 15-year period.

*Example 10. Disposition of retained intangibles by related person.* (i) The facts are the same as in *Example 9*, except that 10 years after the acquisition of the assets by X and Y and seven years after the sale of the assets by X, Y sells all of the assets acquired from Z, including amortizable section 197 intangibles, to an unrelated purchaser.

(ii) Upon the sale of assets by Y, X may recognize a loss equal to the unamortized loss. Accordingly, pursuant to paragraph (g)(1)(iv) of this section, X may recognize a loss in the amount of \$50,000, the amount obtained by reducing the loss on the sale of the assets at the end of the third year (\$120,000) by the amount of amortization allowed for the fourth through the tenth years (\$70,000).

*Example 11. Acquisition of an interest in partnership with no section 754 election.* (i) A, B, and C each contribute \$1,500 for equal shares in general partnership P. On January 1, 1998, P acquires as its sole asset an amortizable section 197 intangible for \$4,500. P still holds the intangible on January 1, 2003, at which time the intangible has an adjusted basis to P of \$3,000, and A, B, and C each have an adjusted basis of \$1,000 in their partnership interests. D (who is not related to A) acquires A's interest in P for \$1,600. No section 754 election is in effect for 2003.

(ii) Pursuant to paragraph (h)(5)(i) of this section, there is no change in the basis or amortization of the intangible and D merely steps into the shoes of A with respect to the intangible. D's proportionate share of P's adjusted basis in the intangible is \$1,000, which continues to be amor-

tized over the 10 years remaining in the original 15-year amortization period for the intangible.

*Example 12. Acquisition of an interest in partnership with a section 754 election.* (i) The facts are the same as in *Example 11*, except that a section 754 election is in effect for 2003.

(ii) Pursuant to section 197(f)(9)(E) and paragraph (h)(5)(i) of this section, for purposes of section 197, D is treated as if P owns two assets. D's proportionate share of P's adjusted basis in one asset is \$1,000, which continues to be amortized over the 10 years remaining in the original 15-year amortization period. For the other asset, D's proportionate share of P's adjusted basis is \$600 (the amount of the basis increase under section 743 as a result of the section 754 election), which is amortized over a new 15-year period beginning January 2003. With respect to B and C, P's remaining \$2,000 adjusted basis in the intangible continues to be amortized over the 10 years remaining in the original 15-year amortization period.

*Example 13. Payment to a retiring partner by partnership with a section 754 election.* (i) The facts are the same as in *Example 11*, except that a section 754 election is in effect for 2003 and, instead of D acquiring A's interest in P, A retires from P. A, B, and C are not related to each other within the meaning of paragraph (h)(6) of this section. A receives a payment under section 736 from P of \$1,600, all of which is in exchange for A's interest in the intangible asset owned by P.

(ii) Pursuant to paragraph (h)(5)(i) of this section, because of the section 734 adjustment, P is treated as having two amortizable section 197 intangibles, one with a basis of \$3,000 and a remaining amortization period of 10 years and the other with a basis of \$600 and a new amortization period of 15 years.

*Example 14. Termination of partnership under section 708(b)(1)(B).* (i) A and B are partners with equal shares in the capital and profits of general partnership P. P's only asset is an amortizable section 197 intangible, which P had acquired on January 1, 1994. On January 1, 1999, the asset had a fair market value of \$100 and a basis to P of \$50. On that date, A sells his entire partnership interest in P to C, who is unrelated to A, for \$50. At the time of the sale, the basis of each of A and B in their respective partnership interests is \$25.

(ii) The sale causes a termination of P under section 708(b)(1)(B). Under section 708, the transaction is treated as if P transfers its sole asset to a new partnership in exchange for the assumption of its liabilities and the receipt of all of the interests in the new partnership. Immediately thereafter, P is treated as if it is liquidated, with B and C each receiving their proportionate share of the interests in the new partnership. The contribution by P of its asset to the new partnership is governed by section 721, and the liquidating distributions by P of the interests in the new partnership are governed by section 731. However, C does not realize a special basis adjustment under section 743 with respect to the amortizable section 197 intangible unless P had a section 754 election in effect for its taxable year in which the deemed transfer of the asset to the new partnership occurred.

(iii) Under section 197, if P had a section 754 election in effect for its taxable year in which the deemed transfer of the asset to the new partnership occurred, C is treated as if the new partnership had acquired two assets from P immediately preceding its termination. Even though the adjusted basis of the new partnership in the two assets is determined solely under section 723, because the transfer of assets is a transaction described in section 721, the application of sec-

tions 743(b) and 754 to P immediately before its termination causes P to be treated as if it held two assets, for purposes of section 197, at this time. B's and C's proportionate share of the new partnership's adjusted basis is \$25 each in one asset, which continues to be amortized over the 10 years remaining in the original 15-year amortization period. For the other asset, C's proportionate share of the new partnership's adjusted basis is \$25 (the amount of the basis increase resulting from the application of section 743 to the sale or exchange by A of the interest in P), which is amortized over a new 15-year period beginning in January 1999.

(iv) If P did not have a section 754 election in effect for its taxable year in which the sale of the partnership interest by A to C occurred, the adjusted basis of the new partnership in the amortizable section 197 intangible is determined solely under section 723, because the transfer is a transaction described in section 721, and P does not have a basis increase in its section 197 intangible. Under section 197(f)(2) and paragraph (g)(2) of this section, the new partnership continues to amortize the amortizable section 197 intangible over the 10 years remaining in the original 15-year amortization period. No additional amortization is allowable with respect to this asset under section 197.

*Example 15. Disguised sale to partnership.* (i) Assume that E and F are individuals who are unrelated to each other within the meaning of paragraph (h)(6) of this section. E has been engaged in the active conduct of a trade or business as a sole proprietor since 1990. E and F form EF Partnership. E transfers all of the assets of the business, having a fair market value of \$100x, to EF, and F transfers \$40x of cash to EF. E receives a 60 percent interest in EF and the \$40x of cash contributed by F, and F receives a 40 percent interest in EF, under circumstances in which the transfer by E is treated as a sale of property to EF under § 1.707-3(b).

(ii) Under § 1.707-3(a)(1), the transaction is treated as if E had sold to EF a 40 percent interest in each asset for \$40x and contributed the remaining 60 percent interest in each asset to EF in exchange solely for an interest in EF. Because E and EF are related persons within the meaning of paragraph (h)(6) of this section, no portion of any transferred section 197 intangible that E held during the transition period (as defined in paragraph (h)(3) of this section) is an amortizable section 197 intangible pursuant to paragraph (h)(1) of this section. Section 197(f)(9)(E) and paragraph (h)(5) of this section do not apply to any portion of the section 197 intangible in the hands of EF because the basis of EF in these assets was not increased under any of sections 732, 734, or 743.

*Example 16. Acquisition by related person in nonrecognition transaction.* (i) A owns a nonamortizable intangible that A acquired in 1990. In 1997, A sells a one-half interest in the intangible to B for cash. Immediately after the sale, A and B, who are unrelated to each other, form partnership P as equal partners. A and B each contribute their one-half interest in the intangible to P.

(ii) P has a transferred basis in the intangible from A and B under section 723. The nonrecognition transfer rule under paragraph (g)(2)(i) of this section applies to A's transfer of its one-half interest in the intangible to P, and consequently P steps into A's shoes with respect to A's nonamortizable transferred basis. The anti-churning rules of paragraph (h)(1)(i) of this section apply to B's transfer of its one-half interest in the intangible to P, because A, who is related to P

under paragraph (h)(6) of this section, held B's one-half interest in the intangible during the transition period. Pursuant to paragraph (h)(10) of this section, these rules apply to B's transfer of its one-half interest to P even though the nonrecognition transfer rule under paragraph (g)(2)(i) of this section would have permitted P to step into B's shoes with respect to B's otherwise amortizable basis. Therefore, P's entire basis in the intangible is nonamortizable.

*Example 17. Acquisition of partnership interest following formation of partnership.* (i) The facts are the same as in Example 16 except that, in 1996, A formed P with an affiliate and contributed the intangible to the partnership and except that thereafter, in an unrelated transaction, B purchases a 50 percent interest in P. P has a section 754 election in effect.

(ii) For the reasons set forth in Example 14(iii), B is treated as if P owns two assets. B's proportionate share of P's adjusted basis in one asset is the same as A's proportionate share of P's adjusted basis in that asset, which is not amortizable under section 197. For the other asset, B's proportionate share of the remaining adjusted basis of P is amortized over a new 15-year period.

*Example 18. Acquisition by related corporation in nonrecognition transaction.* (i) The facts are the same as Example 16, except that P is a corporation.

(ii) P has a transferred basis in the intangible from A and B under section 362. Pursuant to paragraph (h)(10) of this section, the application of the nonrecognition transfer rule under paragraph (g)(2)(i) and the anti-churning rules of paragraph (h)(1)(i) of this section to the facts of this Example 18 is the same as in Example 16. Thus, P's entire basis in the intangible is nonamortizable.

*Example 19. Acquisition from corporation related to purchaser through remote indirect interest.* (i) X, Y, and Z are each corporations that have only one class of issued and outstanding stock. X owns 25 percent of the stock of Y and Y owns 25 percent of the outstanding stock of Z. No other shareholder of any of these corporations is related to any other shareholder or to any of the corporations. On June 30, 1997, X purchases from Z section 197 intangibles that Z owned during the transition period (as defined in paragraph (h)(3) of this section).

(ii) Pursuant to paragraph (h)(6)(iii)(B) of this section, the beneficial ownership interest of X in Z is 6.25 percent, determined by treating X as if it owned a proportionate (25 percent) interest in the stock of Z that is actually owned by Y. Thus, even though X is related to Y and Y is related to Z, X and Z are not considered to be related for purposes of the anti-churning rules of section 197.

*Example 20. Gain recognition election.* (i) B owns 25 percent of the stock of S, a corporation that uses the calendar year as its taxable year. No other shareholder of B or S is related to each other. S is not a member of a controlled group of corporations within the meaning of section 1563(a). S has section 197 intangibles that it owned during the transition period and was not permitted to amortize or depreciate under any other provision of the Code. S had a basis of \$25,000 in the intangibles. In 1997, S sells these intangibles to B for \$75,000. S recognizes a gain of \$50,000 on the sale and has no other items of income, deduction, gain, or loss for the year, except that S also has a net operating loss of \$20,000 from prior years that it would otherwise be entitled to use in 1997 pursuant to section 172(b). As part of the transaction with B, S agrees to make the gain recognition election pursuant to section 197(f)(9)(B).

(ii) If the gain recognition election had not been made, S would have taxable income of \$30,000 for 1997 and a tax liability of \$4,500. As the result of the election, S must pay a total tax liability for the year of \$17,500 (35 percent of \$50,000), consisting of the sum of its regular tax liability of \$4,500 and the additional amount of \$13,000 pursuant to section 197(f)(9)(B).

(iii) Pursuant to paragraph (h)(9)(v)(A) of this section, S determines the amount of its net operating loss deduction in subsequent years without regard to the gain recognized on the sale of the section 197 intangible to B. Accordingly, the entire \$20,000 net operating loss deduction that would have been available in 1997 but for the gain recognition election may be used in 1998, subject to the limitations of section 172.

(iv) B has a basis of \$75,000 in the section 197 intangibles acquired from S. As the result of the gain recognition election by S, B may amortize \$50,000 of its basis under section 197. The remaining basis may not be amortized by B.

*Example 21. Section 338 election.* (i) P corporation makes a qualified stock purchase of the stock of T corporation from two shareholders in July 1997, and a section 338 election is made by P. One of the selling shareholders is an individual who owns 25 percent of the total value of the stock of each of the T and P corporation. No other shareholder of either T or P owns stock in both of these corporations, and no other shareholder is related to any other shareholder of either corporation.

(ii) Old target and new target (as these terms are defined in § 1.338-1(c)(13)) are members of a controlled group of corporations under section 267(b)(3), as modified by section 197(f)(9)(C)(i), and any section 197 intangible held by old target at any time during the transition period is not an amortizable section 197 intangible in the hands of new target. However, a gain recognition election under paragraph (h)(9)(i) of this section may be made with respect to this transaction.

(1) *Effective dates.* This section is applicable on the date final regulations are published in the Federal Register, except that § 1.197-2(c)(13) (exception from section 197 for separately acquired rights of fixed duration or amount) is applicable August 11, 1993 (or July 26, 1991, if a valid retroactive election has been made under § 1.197-1T).

Margaret Milner Richardson,  
Commissioner of Internal Revenue.

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