

IRC and Regulations on Intangibles

§197 Amortization of goodwill and certain other intangibles

- (a) General rule. A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.
- (b) No other depreciation or amortization deduction allowable. Except as provided in subsection (a) , no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 intangible.
- (c) Amortizable section 197 intangible. For purposes of this section —
- (1) In general. Except as otherwise provided in this section , the term “amortizable section 197 intangible” means any section 197 intangible—
- (A) which is acquired by the taxpayer after the date of the enactment of this section , and
 - (B) which is held in connection with the conduct of a trade or business or an activity described in section 212 .
- (2) Exclusion of self-created intangibles, etc. The term “amortizable section 197 intangible” shall not include any section 197 intangible—
- (A) which is not described in subparagraph (D) , (E) , or (F) of subsection (d)(1) , and
 - (B) which is created by the taxpayer.
- This paragraph shall not apply if the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.
- (3) Anti-churning rules. For exclusion of intangibles acquired in certain transactions, see subsection (f)(9) .

- (d) Section 197 intangible. For purposes of this section —

- (1) In general. Except as otherwise provided in this section , the term “ section 197 intangible” means—
- (A) goodwill,
 - (B) going concern value,
 - (C) any of the following intangible items:
 - (i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,
 - (ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),
 - (iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

- (iv) any customer-based intangible,
 - (v) any supplier-based intangible, and
 - (vi) any other similar item,
 - (D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,
 - (E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and
 - (F) any franchise, trademark, or trade name.
- (2) Customer-based intangible.
- (A) In general. The term “customer-based intangible” means—
 - (i) composition of market,
 - (ii) market share, and
 - (iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.
 - (B) Special rule for financial institutions. In the case of a financial institution, the term “customer-based intangible” includes deposit base and similar items.
- (3) Supplier-based intangible. The term “supplier-based intangible” means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.
- (e) Exceptions. For purposes of this section , the term “ section 197 intangible” shall not include any of the following:
- (1) Financial interests. Any interest—
 - (A) in a corporation, partnership, trust, or estate, or
 - (B) under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract.
 - (2) Land. Any interest in land.
 - (3) Computer software.
 - (A) In general. Any—
 - (i) computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and
 - (ii) other computer software which is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(B) Computer software defined. For purposes of subparagraph (A) , the term “computer software” means any program designed to cause a computer to perform a desired function. Such term shall not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

(4) Certain interests or rights acquired separately. Any of the following not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion thereof:

(A) Any interest in a film, sound recording, video tape, book, or similar property.

(B) Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof.

(C) Any interest in a patent or copyright.

(D) To the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right—

(i) has a fixed duration of less than 15 years, or

(ii) is fixed as to amount and, without regard to this section , would be recoverable under a method similar to the unit-of-production method.

(5) Interests under leases and debt instruments. Any interest under—

(A) an existing lease of tangible property, or

(B) except as provided in subsection (d)(2)(B), any existing indebtedness.

(6) Mortgage servicing. Any right to service indebtedness which is secured by residential real property unless such right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than rights described in this paragraph) constituting a trade or business or substantial portion thereof.

(7) Certain transaction costs. Any fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C.

(f) Special rules.

(1) Treatment of certain dispositions, etc.

(A) In general. If there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained—

(i) no loss shall be recognized by reason of such disposition (or such worthlessness), and

(ii) appropriate adjustments to the adjusted bases of such retained intangibles shall be made for any loss not recognized under clause (i) .

(B) Special rule for covenants not to compete. In the case of any section 197 intangible which is a covenant not to compete (or other arrangement) described in subsection (d)(1)(E) , in no event shall such covenant or other arrangement be treated as disposed of (or becoming worthless) before the disposition of the entire interest described in such subsection in connection with which such covenant (or other arrangement) was entered into.

(C) Special rule. All persons treated as a single taxpayer under section 41(f)(1) shall be so treated for purposes of this paragraph .

(2) Treatment of certain transfers.

(A) In general. In the case of any section 197 intangible transferred in a transaction described in subparagraph (B) , the transferee shall be treated as the transferor for purposes of applying this section with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

(B) Transactions covered. The transactions described in this subparagraph are—

(i) any transaction described in section 332 , 351 , 361 , 721 , 731 , 1031 , or 1033 , and

(ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

(3) Treatment of amounts paid pursuant to covenants not to compete, etc. Any amount paid or incurred pursuant to a covenant or arrangement referred to in subsection (d)(1)(E) shall be treated as an amount chargeable to capital account.

(4) Treatment of franchises, etc.

(A) Franchise. The term “franchise” has the meaning given to such term by section 1253(b)(1) .

(B) Treatment of renewals. Any renewal of a franchise, trademark, or trade name (or of a license, a permit, or other right referred to in subsection (d)(1)(D)) shall be treated as an acquisition. The preceding sentence shall only apply with respect to costs incurred in connection with such renewal.

(C) Certain amounts not taken into account. Any amount to which section 1253(d)(1) applies shall not be taken into account under this section .

(5) Treatment of certain reinsurance transactions. In the case of any amortizable section 197 intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible under this section shall be the excess of—

(A) the amount paid or incurred by the acquirer under the assumption reinsurance transaction, over

(B) the amount required to be capitalized under section 848 in connection with such transaction.

Subsection (b) shall not apply to any amount required to be capitalized under section 848 .

- (6) Treatment of certain subleases. For purposes of this section , a sublease shall be treated in the same manner as a lease of the underlying property involved.
- (7) Treatment as depreciable. For purposes of this chapter, any amortizable section 197 intangible shall be treated as property which is of a character subject to the allowance for depreciation provided in section 167 .
- (8) Treatment of certain increments in value. This section shall not apply to any increment in value if, without regard to this section, such increment is properly taken into account in determining the cost of property which is not a section 197 intangible.

(9) Anti-churning rules. For purposes of this section —

(A) In general. The term “amortizable section 197 intangible” shall not include any section 197 intangible which is described in subparagraph (A) or (B) of subsection (d)(1) (or for which depreciation or amortization would not have been allowable but for this section) and which is acquired by the taxpayer after the date of the enactment of this section, if—

- (i) the intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,
- (ii) the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or
- (iii) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before such date of enactment.

For purposes of this subparagraph , the determination of whether the user of property changes as part of a transaction shall be determined in accordance with regulations prescribed by the Secretary. For purposes of this subparagraph, deductions allowable under section 1253(d) shall be treated as deductions allowable for amortization.

(B) Exception where gain recognized. If—

- (i) subparagraph (A) would not apply to an intangible acquired by the taxpayer but for the last sentence of subparagraph (C)(i) , and
- (ii) the person from whom the taxpayer acquired the intangible elects, notwithstanding any other provision of this title—

(I) to recognize gain on the disposition of the intangible, and

(II) to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest rate of income tax applicable to such person under this title,

then subparagraph (A) shall apply to the intangible only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized under clause (ii)(I) .

(C) Related person defined. For purposes of this paragraph —

(i) Related person. A person (hereinafter in this paragraph referred to as the “related person”) is related to any person if—

(I) the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1) , or

(II) the related person and such person are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1)).

For purposes of subclause (I) , in applying section 267(b) or 707(b)(1) , “20 percent” shall be substituted for “50 percent”.

(ii) Time for making determination. A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

(D) Acquisitions by reason of death. Subparagraph (A) shall not apply to the acquisition of any property by the taxpayer if the basis of the property in the hands of the taxpayer is determined under section 1014(a) .

(E) Special rule for partnerships. With respect to any increase in the basis of partnership property under section 732 , 734 , or 743 , determinations under this paragraph shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.

(F) Anti-abuse rules. The term “amortizable section 197 intangible” does not include any section 197 intangible acquired in a transaction, one of the principal purposes of which is to avoid the requirement of subsection (c)(1) that the intangible be acquired after the date of the enactment of this section or to avoid the provisions of subparagraph (A) .

(10) Tax-exempt use property subject to lease. In the case of any section 197 intangible which would be tax-exempt use property as defined in subsection (h) of section 168 if such section applied to such intangible, the amortization period under this section shall not be less than 125 percent of the lease term (within the meaning of section 168(i)(3)).

(g) Regulations. The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section , including such regulations as may be appropriate to prevent avoidance of the purposes of this section through related persons or otherwise.

§197 Regulations [excerpt]

§1.197-2(c)(4) *Certain computer software.*

- (i) Publicly available. 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 license, and has not been substantially modified. 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. This requirement can be met even though the software is not available through a system of retail distribution. Computer software will not be considered to have been substantially modified if the cost of all modifications to the version of the software that is readily available to the general public does not exceed the greater of 25 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 on a system is not treated as a cost of the software. However, the costs for customization, such as tailoring to a user's specifications (other than embedded programming options) are costs of modifying the software.
- (ii) Not acquired as part of trade or business. 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.
- (iii) Other exceptions. For other exceptions applicable to computer software, see paragraph (a)(3) of this section (relating to otherwise deductible amounts) and paragraph (g)(7) of this section (relating to amounts properly taken into account in determining the cost of property that is not a section 197 intangible).
- (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 to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. 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.

(c)(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. A patent or copyright 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. (See §1.167(a)-14(c)(4) for applicable rules.)

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

Example (1). Advertising costs. (i) Q manufactures and sells consumer products through a series of wholesalers and distributors. In order to increase sales of its products 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.

(ii) The advertising costs are not chargeable to capital account under paragraph (f)(3) of this section (relating to costs incurred for covenants not to compete, rights granted by governmental units, and contracts for the use of section 197 intangibles) and are currently deductible as ordinary and necessary expenses under section 162. Accordingly, under paragraph (a)(3) of this section, section 197 does not apply to these costs.

Example (2). 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 developer modified the software for use by Y at a cost of \$1,000 and Y made additional modifications at a cost of \$500. 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. In addition, the software is not substantially modified because the cost of the modifications by the developer and Y to the version of the software that is readily available to the general public does not exceed \$2,000. Accordingly, the software is not a section 197 intangible.

Example (3). Acquisition of software for internal use. (i) B, the owner and operator of a worldwide package-delivery service, purchases from S all rights to software developed by S.

The software will be used by B for the sole purpose of improving its package-tracking operations. B does not purchase any other assets in the transaction or any related transaction.

(ii) Because B acquired the software solely for internal use, it is disregarded in determining for purposes of paragraph (c)(4)(ii) of this section whether the assets acquired in the transaction or series of related transactions constitute a trade or business or substantial portion thereof. Since no other assets were acquired, the software is not acquired as part of a purchase of a trade or business and under paragraph (c)(4)(ii) of this section is not a section 197 intangible.

Example (4). 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.

(ii) The right granted by M is a right to receive tangible property or services described in section 197(e)(4)(B) and paragraph (c)(6) of this section and, thus, is not a section 197 intangible. This exclusion applies even though the right does not qualify for exclusion as a right of fixed duration or amount under section 197(e)(4)(D) and paragraph (c)(13) of this section because the duration exceeds 15 years and the right is not fixed as to amount. It is also immaterial that the right would not qualify for exclusion as a self-created intangible under section 197(c)(2) and paragraph (d)(2) of this section because it is granted by a governmental unit.

Example (5). Separate acquisition of franchise. (i) S is a franchiser of retail outlets for specialty coffees. G enters into a franchise agreement (within the meaning of section 1253(b)(1)) 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, throughout the term of the franchise, additional amounts that are deductible under section 1253(d)(1). 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 that are deductible under section 1253(d)(1) 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 (6). 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. The amounts payable to C under the agreement are not contingent payments for purposes of §1.1275-4. The present fair market value of B's rights under the agreement is \$225,000. The aggregate consideration paid excluding any amount treated as interest or original issue discount under applicable provisions of the Internal Revenue Code, for all assets acquired in the transaction (including the covenant not to compete) exceeds the sum of the amount of Class I assets and the aggregate fair market value of all Class II, Class III, Class IV, Class V, and Class VI assets by \$50,000. See §1.338-6(b) for rules for determining the assets in each class.

(ii) Because the covenant is acquired in an applicable asset acquisition (within the meaning of section 1060(c)), paragraph (f)(4)(ii) of this section applies and the basis of B in the covenant is determined pursuant to section 1060(a) and the regulations thereunder. Under §§1.1060-1(c)(2) and 1.338-6(c)(1), B's basis in the covenant cannot exceed its fair market value. Thus, B's basis in the covenant immediately after the acquisition is \$225,000. This basis is amortized ratably over the 15-year period beginning on the first day of the month in which the agreement is entered into. All of the remaining consideration after allocation to the covenant and other Class VI assets, (\$50,000) is allocated to Class VII assets (goodwill and going concern value). See §§1.1060-1T(c)(2) and 1.338-6T(b).

Example (7). Stand-alone license of technology. (i) X is a manufacturer of consumer goods that does business throughout the world through subsidiary corporations organized under the laws of each country in which business is conducted. X licenses to Y, its subsidiary organized and conducting business in Country K, all of the patents, formulas, designs, and know-how necessary for Y to manufacture the same products that X manufactures in the United States. Assume that the license is not considered a sale or exchange under the principles of section 1235. The license is for a term of 18 years, and there are no facts to indicate that the license does not have a fixed duration. Y agrees to pay X a royalty equal to a specified, fixed percentage of the revenues obtained from selling products manufactured using the licensed technology. Assume that the royalty is reasonable and is not subject to adjustment under section 482. The license is not entered into in connection with any other transaction. Y incurs capitalized costs in connection with entering into the license.

(ii) The license is a contract for the use of a section 197 intangible within the meaning of paragraph (b)(11) of this section. It does not qualify for the exception in section 197(e)(4)(D) and paragraph (c)(13) of this section (relating to rights of fixed duration or amount because it does not have a term of less than 15 years, and the other exceptions in section 197(e) and paragraph (c) of this section are also inapplicable. Accordingly, the license is a section 197 intangible.

(iii) The license is not acquired as part of a purchase of a trade or business. Thus, under paragraph (f)(3)(iii) of this section, the license will be closely scrutinized under the principles of section 1235 for purposes of determining whether the transfer is a sale or exchange and, accordingly, whether the payments under the license are chargeable to capital account. Because the license is not a sale or exchange under the principles of section 1235, the royalty payments are not chargeable to capital account for purposes section 197. The capitalized costs of entering into the license are not within the exception under paragraph (d)(2) of this section for self-created intangibles, and thus are amortized under section 197.

Example (8). License of technology and trademarks.

(s) The facts are the same as in Example 7, except that the license also includes the use of the trademarks and trade names that X uses to manufacture and distribute its products in the United States. Assume that under the principles of section 1253 the transfer is not a sale or

exchange of the trademarks and trade names or an undivided interest therein and that the royalty payments are described in section 1253(d)(1)(B).

(ii) As in Example 7, the license is a section 197 intangible. Although the license conveys an interest in X's trademarks and trade names to Y, the transfer of the interest is disregarded for purposes of paragraph (e)(2) of this section unless the transfer is considered a sale or exchange of the trademarks and trade names or an undivided interest therein. Accordingly, the licensing of the technology and the trademarks and trade names is not treated as part of a purchase of a trade or business under paragraph (e)(2) of this section.

(iii) Because the technology license is not part of the purchase of a trade or business, it is treated in the manner described in Example 7. The royalty payments for the use of the trademarks and trade names are deductible under section 1253(d)(1) and, under section 197(f)(4)(C) and paragraph (b)(10)(ii) of this section, are not chargeable to capital account for purposes of section 197. The capitalized costs of entering into the license are treated in the same manner as in example 7.

Example (9). Disguised sale. (i) The facts are the same as in Example 7, except that Y agrees to pay X, in addition to the contingent royalty, a fixed minimum royalty immediately upon entering into the agreement and there are sufficient facts present to characterize the transaction, for federal tax purposes, as a transfer of ownership of the intellectual property from X to Y.

(ii) The purported license of technology is, in fact, an acquisition of an intangible described in section 197(d)(1)(C)(iii) and paragraph (b)(5) of this section (relating to know-how, etc.). As in Example 7, the exceptions in section 197(e) and paragraph (c) of this section do not apply to the transfer. Accordingly, the transferred property is a section 197 intangible. Y's basis in the transferred intangible includes the capitalized costs of entering into the agreement and the fixed minimum royalty payment payable at the time of the transfer. In addition, except to the extent that a portion of any payment will be treated as interest or original issue discount under applicable provisions of the Internal Revenue Code, all of the contingent payments under the purported license are properly chargeable to capital account for purposes of section 197 and this section. The extent to which such payments are treated as payments of principal and the time at which any amount treated as a payment of principal is taken into account in determining basis are determined under the rules of §1.1275-4(c)(4) or 1.483-4(a), whichever is applicable. Any contingent amount that is included in basis after the month in which the acquisition occurs is amortized under the rules of paragraph (f)(2)(i) or (ii) of this section.

Example (10). License of technology and customer list as part of sale of a trade or business.

(i) X is a computer manufacturer that produces, in separate operating divisions, personal computers, servers, and peripheral equipment. In a transaction that is the purchase of a trade or business for purposes of section 197, Y (who is unrelated to X) purchases from X all assets of the operating division producing personal computers, except for certain patents that are also used in the division manufacturing servers and customer lists that are also used in the division manufacturing peripheral equipment. As part of the transaction, X transfers to Y the right to use the retained patents and customer lists solely in connection with the manufacture and sale of personal computers. The transfer agreement requires annual royalty payments contingent on the use of the patents and also requires a payment for each use of the customer list. In addition, Y incurs capitalized costs in connection with entering into the licenses.

(ii) The rights to use the retained patents and customer lists are contracts for the use of section 197 intangibles within the meaning of paragraph (b)(11) of this section. The rights do not qualify for the exception in 197(e)(4)(D) and paragraph (c)(13) of this section (relating to rights of fixed duration or amount) because they are transferred as part of a purchase of a

trade or business and the other exceptions in section 197(e) and paragraph (c) of this section are also inapplicable. Accordingly, the licenses are section 197 intangibles.

(iii) Because the right to use the retained patents is described in paragraph (b)(11) of this section and the right is transferred as part of a purchase of a trade or business, the treatment of the royalty payments is determined under paragraph (f)(3)(ii) of this section. In addition, however, the retained patents are described in paragraph (b)(5) of this section. Thus, the annual royalty payments are chargeable to capital account under the general rule of paragraph (f)(3)(ii)(A) of this section unless Y establishes that the license is not a sale or exchange under the principles of section 1235 and the royalty payments are an arm's length consideration for the rights transferred. If these facts are established, the exception in paragraph (f)(3)(ii)(B) of this section applies and the royalty payments are not chargeable to capital account for purposes of section 197. The capitalized costs of entering into the license are treated in the same manner as in Example 7.

(iv) The right to use the retained customer list is also described in paragraph (b)(11) of this section and is transferred as part of a purchase of a trade or business. Thus, the treatment of the payments for use of the customer list is also determined under paragraph (f)(3)(ii) of this section. The customer list, although described in paragraph (b)(6) of this section, is a customer-related information base. Thus, the exception in paragraph (f)(3)(ii)(B) of this section does not apply. Accordingly, payments for use of the list are chargeable to capital account under the general rule of paragraph (f)(3)(ii)(A) of this section and are amortized under section 197. In addition, the capitalized costs of entering into the contract for use of the customer list are treated in the same manner as in Example 7.