

Internal Revenue Service
Memorandum

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CC:LB&I:HMP:BOS1:CWMaurer

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date: February 20, 2015

to: LB&I Heavy Manufacturing & Pharmaceuticals,

from: Associate Area Counsel, Boston

CC:LB&I:HMP:Bos1

subject: I.R.C. §§ 382 and 482

Note: Please ignore the attached memorandum dated November 3, 2014 and replace with this revised memorandum dated February 20, 2015. Due to inadequate coordination by the National Office, the first version did not receive appropriate review.

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

TAXPAYER =

LOSS CORP =

FOREIGN SUB =

CONSULTNG FIRM =

ACCOUNTING FIRM =

AMOUNT 1 =

AMOUNT 2 =

AMOUNT 3 =

AMOUNT 4 =

AMOUNT 5 =

AMOUNT 6 =

AMOUNT 7 =

AMOUNT 8 =

DATE 1 =

DATE 2 =

DATE 3 =

DATE 4 =

DATE 5 =

DATE 6 =

DATE 7 =

YEAR 1 =

YEAR 2 =

CONTRACT 1 =

CONTRACT 2 =

PRODUCT A =

ACTIVITY 1 =

INTANGIBLE =

PROPERTY

ISSUE

What is the appropriate treatment of TAXPAYER's transfer of rights in LOSS CORP INTANGIBLE PROPERTY ("I/P")¹ to FOREIGN SUB under I.R.C. sections 382 and 482?

CONCLUSION

TAXPAYER allocated \$AMOUNT 1 of the total \$AMOUNT 2 purchase price of LOSS CORP's stock to the LOSS CORP I/P. TAXPAYER has not demonstrated that the platform contribution transaction ("PCT") payment ("PCT Payment") provided pursuant to CONTRACT 2 is attributable solely to the LOSS CORP I/P (as opposed to other platform contributions) as of the change date. TAXPAYER argues that the entire \$AMOUNT 1 payment it received for the transfer of I/P rights should be treated as recognized built-in gains ("RBIGs") under section 382 in the year the payment was properly included in income. TAXPAYER also argues that under the terms of

¹ TAXPAYER appears to have transferred to FOREIGN SUB make-or-sell rights to the LOSS CORP I/P in addition to rights to the LOSS CORP I/P for future intangible development activity. It appears that FOREIGN SUB's platform contribution transaction payment was intended to compensate TAXPAYER for all rights it transferred to FOREIGN SUB in LOSS CORP I/P.

CONTRACT 2, the transaction was a license of rights in the I/P, but that nonetheless it should be treated as a sale for section 382 purposes. TAXPAYER argues sale treatment is appropriate because the transaction was an economic disposition of the I/P. First, we disagree that any license of property should be treated as a sale under section 382. Second, considering only the written terms of CONTRACT 2 and the Amended CSA, we disagree that the transaction is an economic disposition of the I/P rights. Additionally, an adjustment under section 482 may be appropriate with respect to the LOSS CORP I/P transferred depending on all the facts and circumstances.

A. BACKGROUND

On July 29, 2010, TAXPAYER submitted a request for a private letter ruling (“PLR”) on the following issues:

TAXPAYER withdrew the PLR request because the Service only allowed Taxpayer to recognize the built-in gain allowed under the 338 approach of Notice 2003-65.²

On July 28, 2011, TAXPAYER submitted a request for a pre-filing agreement (“PFA”) on the same issues. The PFA request was not resolved prior to the filing of TAXPAYER’s return on DATE 1, and the case is now under examination.

B. FACTS--Determining the Part of the \$AMOUNT 1 PCT Payment that was Paid for Items other than the LOSS CORP I/P

The PFA request was not accepted, in part, because there was no opportunity to

² The 338 approach in Notice 2003-65 identifies built-in gain by comparing actual items of income, gain, loss, and deduction with such items if a hypothetical section 338 election was made. Under the 338 approach, it is assumed that an asset that had a built-in gain on the change date generates income equal to what would have been its allowed cost recovery deduction during the recognition period based upon the fair market value basis of the asset on the change date. Under the 338 approach, TAXPAYER may determine RBIGs by calculating the amount of amortization of the I/P during the 5-year recognition period under section 197 (which provides for 15 year straight-line amortization).

develop the facts prior to the filing of TAXPAYER's return for the year in issue. The following summary of the facts is based upon statements and documents submitted by TAXPAYER in connection with the PLR and PFA requests. These facts have not been examined and have not been verified by our office.

On DATE 2, TAXPAYER, a domestic corporation, acquired all of the outstanding stock of LOSS CORP, a domestic ACTIVITY 1 corporation, in exchange for cash of \$AMOUNT 2, which resulted in an ownership change under section 382 for LOSS CORP on that date. Thereafter, on the same date, LOSS CORP liquidated into TAXPAYER. LOSS CORP had been a loss corporation for purposes of section 382 since its inception in DATE 3. In a report prepared by CONSULTING FIRM dated DATE 4, the purchase price was allocated among various assets including "Developed Technology" in the amount of \$AMOUNT 3 and "Goodwill" of \$AMOUNT 4. TAXPAYER is claiming RBIG only with respect to the PCT Payment of \$AMOUNT 1 (which likely reflects a portion of the value of the Developed Technology) with respect to the I/P of LOSS CORP, and is not attempting to claim RBIG for the Goodwill.

Both the PLR request and the PFA request include a chart showing LOSS CORP's "economic activity" for the years YEAR 1 through YEAR 2. PLR request, page 3; PFA request, page 3. According to the chart, LOSS CORP's total "Gross Revenue" during this period was \$AMOUNT 5 and its total "Taxable Income/(Loss)" was (\$AMOUNT 6). This loss resulted, in part, from "R&D Expense" in a total amount of \$AMOUNT 7. However, during the same period, the total "Compensation Deduction" was \$AMOUNT 8.

FOREIGN SUB is an Irish company that is wholly-owned by TAXPAYER. On DATE 5 and DATE 6, respectively, officers of TAXPAYER and FOREIGN SUB signed CONTRACT 1 intended to constitute a cost sharing arrangement for purposes of the section 482 regulations (hereinafter referred to as the "Amended CSA"), effective DATE 7.³ As described in the PLR request:

³ We express no opinion regarding whether DATE 7 is, in fact, the actual start date of the Amended CSA.

PLR request, pages 4-5; PFA request, pages 4-5.

To summarize, the acquisition by TAXPAYER of the Developed Technology resulted in a PCT pursuant to the Amended CSA and the cost sharing rules in Temp. Treas. Reg. § 1.482-7T, thus, necessitating a PCT Payment from FOREIGN SUB to TAXPAYER.⁴ It is the characterization of that PCT Payment for section 382 purposes that was the subject of the PLR and PFA requests.

Article 5.1 of the Amended CSA provides that in consideration of FOREIGN SUB sharing the intangible development costs under the Amended CSA, TAXPAYER grants:

⁴ We express no opinion regarding the correctness of the PCT Payment, including whether it was, in actuality, a payment in whole or in part with respect to make-or-sell rights (within the meaning of Temp. Treas. Reg. § 1.482-7T(c)(4)) and whether it constituted an arm's length price, regardless of the nature of the transaction.

This “royalty-free” license allows FOREIGN SUB to sell
.”⁵ The term “Products” is defined in Article 1.23 as

.” In other words, the Amended
CSA does not grant FOREIGN SUB any royalty-free rights in the LOSS CORP I/P
itself. The LOSS CORP I/P, as “acquired intangibles,” constitute platform
contributions that are the subject of PCTs requiring arm’s length PCT Payments
under the Amended CSA and CONTRACT 2.

CONTRACT 2 provides as follows with respect to the LOSS CORP I/P:

TAXPAYER provided an undated report prepared by ACCOUNTING FIRM entitled

” The report describes its objective as follows:

⁵ The license is not actually “free.” Under the cost sharing rules, no additional payment is required with respect to intangible property resulting from the Amended CSA (and, therefore, it may be thought of as “royalty free”), provided that the requisite cost sharing transaction payments and arm’s length PCT Payments have been made in accordance with the regulations. See Temp. Treas. Reg. § 1.482-7T(a)(4).

The report summarizes its conclusions as follows:

In summary, the Amended CSA required a payment for platform contributions, including the LOSS CORP I/P, as well as the sharing of costs reasonably anticipated to contribute to developing intangibles under the Amended CSA. CONTRACT 2 set forth a “license fee” for the LOSS CORP I/P, with a “preliminary payment”⁶ of \$AMOUNT 1. It appears that this amount was based upon the ACCOUNTING FIRM report. Based on the facts provided, TAXPAYER has not demonstrated that the PCT Payment provided pursuant to CONTRACT 2 is attributable solely to the LOSS CORP I/P (as opposed to other platform contributions) as of the change date.

C. LAW AND ANALYSIS

1. Applying Section 382 to the PCT

Section 382 limits, after a more than 50 percent change in stock ownership (“ownership change”), the amount of a loss corporation’s taxable income for any post-change year that may be offset by pre-change losses. The amount of the limitation for each year is equal to the product of the fair market value of all the stock of the loss corporation immediately before the ownership change multiplied by the applicable long-term tax-exempt rate (“section 382 limitation”).

Section 382(h)(1)(A) provides that if the loss corporation has a “net unrealized built-in gain” (“NUBIG”), the section 382 limitation for any taxable year ending within a 5-year

⁶ We note that, although CONTRACT 2 refers to a “preliminary payment,” thus, implying that additional payments would follow, our understanding is that no additional payments were made.

recognition period is increased by the RBIG for the taxable year, subject to the NUBIG limitation. Section 382(h)(3)(A)(i) provides:

- (3) Net unrealized built-in gain and loss defined.--
 - (A) Net unrealized built-in gain and loss.--
 - (i) In general.--The terms “net unrealized built-in gain” and “net unrealized built-in loss” mean, with respect to any old loss corporation, the amount by which--(I) the fair market value of the assets of such corporation immediately before an ownership change is more or less, respectively, than
 - (II) The aggregate adjusted basis of such assets at such time.

Section 382(h) provides, in essence, two definitions for RBIG. Section 382(h)(2)(A) defines RBIG, and then section 382(h)(6)(A) provides that certain “income items” are treated as RBIG. Specifically, section 382(h)(2)(A) provides as follows:

- (2) Recognized built-in gain and loss.--
 - (A) Recognized built-in gain.--The term “recognized built-in gain” means any gain recognized during the recognition period on the disposition of any asset to the extent the new loss corporation establishes that--
 - (i) such asset was held by the old loss corporation immediately before the change date, and (ii) such gain does not exceed the excess of--
 - (I) the fair market value of such asset on the change date, over
 - (II) The adjusted basis of such asset on such date.

Section 382(h)(6)(A) sets forth a special rule for certain “income items”:

- (6) Treatment of certain built-in items.--
 - (A) Income items.--Any item of income which is properly taken into account during the recognition period but which is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account.

TAXPAYER's Position

Section 382(h)(2) generally requires a “disposition” in order for gain to be considered

recognized built-in gain. In the PFA request, TAXPAYER takes the position that the transfer described in CONTRACT 2 cannot be considered a “disposition” within the meaning of section 382(h)(2)⁷:

However, TAXPAYER nonetheless argues that the transaction should be treated as if it were a sale for purposes of section 382 arguing:

PFA request, page 8. See also PLR Second Supplemental Submission, May 24, 2011, page 6.

TAXPAYER points out that because it received the \$AMOUNT 1 in the first year of the recognition period, the payment was properly taken into account in that year, and the payment was the entire amount that TAXPAYER would receive under the contract, so the payment should be treated as RBIG in that year.

TAXPAYER also points to the 1988 amendment of section 382(h)(6) (“1988 Act”), which changed the language from “accrue on” to “attributable to” arguing that, in light of the change provided for in the 1988 Act, section 382(h)(6)(A) should be interpreted as including items of income that have economically accrued as of a given change date but that are effectively disposed of in the post-change period. PFA request, page 25. See also PLR Second Supplemental Submission, May 4, 2011, page 7.

TAXPAYER further asserts that although the term “attributable to periods before the change date” is not specifically defined for purposes of section 382(h)(6)(A), the plain

⁷ Because of the highly factual nature of the inquiry, we have not examined whether TAXPAYER has actually disposed of all its rights in the LOSS CORP I/P. This determination must be made by the audit team based on the economic substance of the transaction and the conduct of the parties. If TAXPAYER transferred all of its rights, in substance, section 382(h)(2) may apply.

meaning of this term would seem to describe items closely tied to the pre-change period. PFA request, page 26. See also PLR Supplemental Submission, May 4, 2011, page 8.

The Service's Response

First, we disagree that section 382(h)(6) was added to the code to deal with so-called economic dispositions. Under section 382 as revised in the 1986 Act, taxpayers could only recognize built-in gain on the disposition of an asset under section 382(h)(2). At that time, section 382(h)(6) merely provided that “the Secretary may by regulation treat amounts which accrue on or before the change date but which are allowable as a deduction after such date as recognized built-in losses.” The joint committee report accompanying the 1986 Act notes that “section 382 does not provide relief for built-in income other than gain on the disposition of an asset.”⁸ Therefore, TAXPAYER's argument with respect to a supposed change of language between 1986 and 1988 regarding income items is not correct.

The legislative history of the 1988 Act does not specifically state why the “attributable to” language was added in 1988 other than stating that “the amendment clarifies that any item of income which is properly taken into account during the recognition period but is attributable to periods before the change date shall be treated as recognized built-in gain for the year in which it is properly taken into account.”⁹ The committee reports give three examples of income items: 1) accounts receivable of a cash basis taxpayer that arose before the change date and are collected after that date; 2) the gain on completion of a long-term contract performed by a taxpayer using the completed contract method of accounting that is attributable to the pre-change period; and 3) the recognition of income attributable to the pre-change period pursuant to section 481 adjustments, as when the loss corporation is required to change to the accrual method. See H. Rep. No. 100-795, 46 (1988); S. Rep. No. 100-445, 48 (1988). These three examples provide support that “attributable to” means the period in which the income item was earned. In the case of the PCT Payment, the income was earned when the property was provided to the licensee, so the entire payment was earned in the post-change period and, therefore, could not be attributable to a pre-change period.

Second, we disagree with TAXPAYER as to whether the PCT is economically similar to a sale. Based on the express terms of CONTRACT 2 and the Amended CSA, the transfer is not economically similar to a sale. The terms of the transfer state that the LOSS CORP I/P is licensed on a non-exclusive basis, thus, indicating that

⁸ Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514, JCS-10-87 (May 4, 1987), fn. 38.

⁹ Committee on Ways and Means House of Representative, Miscellaneous Revenue Act of 1988 (H.R. 4333), (August 3, 1988).

TAXPAYER retained the valuable right to further license the exact same rights to other parties. In addition, either party may terminate the license upon 60 days written notice, in which event, TAXPAYER would reacquire the I/P rights held by FOREIGN SUB. The plain language of CONTRACT 2 and the Amended CSA describe a license of certain property rights and not a disposition of all rights to the I/P, whether actual or economic.

We are concerned TAXPAYER's argument leads to inconsistently treating the PCT as a sale for purposes of section 382 but a license for purposes of section 482. By claiming that the transaction is an economic disposition, Taxpayer may be suggesting the actual facts are that neither party has the right to terminate the agreements, TAXPAYER does not have the right to license the LOSS CORP I/P to any other party, and the transfer was intended to be a permanent disposition of the LOSS CORP I/P. Evidence with respect to such facts would be uniquely in the possession of Taxpayer. If such evidence exists, Taxpayer should produce it. Whether a transaction constitutes a disposition or sale as opposed to a license is determined by taking into account all the facts and circumstances establishing the economic substance of the transaction. Further, that determination should be applied consistently for both sections 382 and 482.

2. Applying Section 482 to the PCT

Temp. Treas. Reg. § 1.482-7T(b), requires participants in a cost sharing arrangement ("CSA") to share the costs and risks of developing cost shared intangibles in proportion to their reasonably anticipated benefits. In addition, all controlled participants must engage in PCTs to the extent that platform contributions are made to the CSA. Temp. Treas. Reg. § 1.482-7T(b)(1)(ii). PCT payments must be priced according to arm's length principles.

TAXPAYER acquired LOSS CORP and contributed LOSS CORP's I/P to the Amended CSA. As a result, FOREIGN SUB was required to make an arm's length PCT Payment to TAXPAYER for the platform contribution, in addition to an arm's length payment for any make-or-sell rights that it received. The terms of the Amended CSA and CONTRACT 2, on their face, indicate that the PCT was structured by TAXPAYER as a non-exclusive, perpetual license of resources, capabilities, and rights to FOREIGN SUB. Although TAXPAYER purports to have structured the PCT as a non-exclusive license, under Temp. Treas. Reg. § 1.482-7T(c)(2)(i) it is presumed that the platform contribution is exclusive. TAXPAYER has the burden to rebut the presumption of exclusivity. See Temp. Treas. Reg. § 1.482-7T(c)(2)(ii).

Further, TAXPAYER has claimed there was an economic disposition of the LOSS CORP I/P resulting from CONTRACT 2. The provisions of a CSA must be interpreted by reference to the economic substance of the transaction and the actual conduct of the controlled participants. See Temp. Treas. Reg. § 1.482-7T(k)(1)(iv). Such a

determination depends on all of the facts and circumstances. It is not clear if TAXPAYER reached its conclusion of economic disposition solely from examining the terms of CONTRACT 2 and the CSA or from additional information concerning the relevant facts and circumstances. Therefore, the audit team should request clarification from Taxpayer about whether there are facts in addition to the terms of the documents relevant to determining whether the PCT constituted something other than a non-exclusive license terminable by either party upon 60 days written notice.

Litigation Hazards.

[REDACTED]

[REDACTED]

[REDACTED]

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Please call (617) 788-0809 if you have any further questions.

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