

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: LB&I Heavy Manufacturing & Pharmaceuticals,

from: Associate Area Counsel, Boston
CC:LB&I:HMP:Bos1

subject: Section 382

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

LEGEND

TAXPAYER =
LOSS CORP =
FOREIGN SUB =
FIRM A =
FIRM A-Tax =

ISSUE

Whether domestic TAXPAYER's receipt of a \$ million advanced lease payment in a Platform Contribution Transaction (PCT) from its foreign subsidiary in the first year of the recognition period following a section 382 ownership change should be treated as Recognized Built-In Gain (RBIG) under section 382(h) in that year? TAXPAYER argues the lease payment constitutes (1) an item of income included in gross income during the recognition period but earned during the pre-change period and therefore constitutes RBIG because it is attributable to the pre-change period, or (2) income from the consumption of the built-in gain of a wasting asset, i.e., the "economic disposition" of certain intangible property (I/P) economically similar to a sale of the I/P?

CONCLUSION

Based on the information available, we believe that TAXPAYER has not established that the PCT payment in this case should be treated as RBIG. First, there are significant factual questions that at least some of the payment is not related to the leasing of the I/P. More factual development is required to determine what portion of the PCT payment is for the lease of the I/P as opposed to other items contributed to the joint research program. We discuss this more fully in Section B, below. Second, even assuming or to the extent the payment is for the use of the I/P, TAXPAYER has not established what portion, if any, of the payment was either earned in the pre-change period, or relates to consuming the asset's built-in gain in the recognition period (as opposed to merely the receipt of rent for using the property in the recognition period or from increases in value from market forces). We discuss this more fully in sections C1 and C2, respectively, below.

A. BACKGROUND

On _____, TAXPAYER submitted a request for a Private Letter Ruling on the following issues:

Due to unresolved factual questions regarding the issues TAXPAYER withdrew the ruling request.

On _____, TAXPAYER submitted a request for a Pre-Filing Agreement on the same issues. The request was not resolved prior to the filing of TAXPAYER's return in _____, and the case is now under examination.

B. FACTS-- Determining the Part of the \$ _____ million PCT Payment that is not for the I/P Lease

As indicated, the PLR request was withdrawn due to unresolved factual questions, and the PFA request was not accepted in part because there was no opportunity to 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 as part of the PLR request and the request for a PFA. These facts have not been examined and have not been verified by our office.

On _____, TAXPAYER, a domestic corporation, acquired all of the outstanding stock of LOSS CORP, a domestic " _____ " corporation, in exchange for cash of \$ _____ million, 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 I.R.C. §382 since its inception in _____. In a report prepared by FIRM A dated _____, the purchase price was allocated among various assets including "Developed Technology" in an amount of \$ _____ and "Goodwill" of \$ _____, using the residual method. TAXPAYER is claiming RBIG only with respect to the PCT payment of \$ _____ million (which is likely a portion of the "Developed Technology) 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 _____. LOSS CORP's total "Gross Revenue" during this period was \$ _____ M and its total "Taxable Income/(Loss)" was (\$ _____ M). This loss resulted in part from "R&D Expense" in a total amount of \$ _____ M. However, during the same period, the total "Compensation Deduction" was \$ _____ M.

FOREIGN SUB ("FOREIGN SUB") is an Irish company that is wholly-owned by TAXPAYER.

On _____, respectively, officers of TAXPAYER and FOREIGN SUB executed an "

request: _____ . As described in the PLR

It is the characterization of this payment that was the subject of the PLR request and the PFA request.

TAXPAYER's description of the Amended CSA, quoted above, is not accurate. The phrase used in the PLR and PFA requests -- "

" -- does not appear in the Amended CSA. A similar, but not identical phrase, does appear in the Buy-In License Agreement.

of the Amended CSA provides that "acquired intangibles" may be added to the joint research program by execution of a separate agreement, including "

." [Emphasis added.] In other words, the Amended CSA does not grant FOREIGN SUB a "royalty-free" license to use the existing TAXPAYER intangible property. The Amended CSA requires an arm's length royalty payment to the extent that such intangible property is included in the joint research program.

of the Amended CSA then provides that in consideration of FOREIGN SUB sharing the intangible development costs under the Amended CSA, TAXPAYER grants --

This "royalty-free" license is not for the use of the LOSS CORP I/P, but rather to allow FOREIGN SUB to sell " . The term "Products" is defined in

." In other words, the CSA does not grant FOREIGN SUB any royalty-free rights in the LOSS CORP I/P itself. The LOSS CORP I/P, as an "acquired intangible," is eligible to be included in the Amended CSA, upon payment of an arm's length royalty. The LOSS CORP I/P may then be used in the joint research program to develop new intangibles, which may be incorporated into "Products." then grants FOREIGN SUB a "royalty-free" license to sell such Products which incorporate the Developed Intangible Property.

The LOSS CORP I/P was in fact added to the Amended CSA in a separate " , " which provided as follows:

TAXPAYER provided an undated report prepared by 0-Tax entitled report describes its objective as follows:

." The

The report summarizes its conclusions as follows:

In summary, the Amended CSA provides for an "arm's length" royalty payment in order to include any "acquired intangibles" in the joint research program. The Amended CSA then grants FOREIGN SUB a "royalty-free" license to sell products that embody intangibles that are developed in the course of the joint research program. The Buy-In Agreement sets forth a "license fee" for the LOSS CORP I/P, with a "preliminary payment" of \$ _____ million. It appears that this amount was based upon the FIRM A-Tax report, but -- as will be discussed below -- the FIRM A-Tax report is directed at determining a platform contribution transaction payment under the Amended CSA. A PCT payment cannot be considered the equivalent of a royalty payment or license fee.

1. The LOSS CORP loss is not attributable solely to development of the software that was included in the Amended CSA.

TAXPAYER at _____ of the LOSS CORP tax loss is attributable to research and development costs, and acknowledges that all of the alleged "licensing" income is "post-change." However, TAXPAYER goes on to argue as though the entire loss is attributable to development of the software, that the entire platform contribution transaction payment is attributable to the use of that software, and that the entire platform contribution transaction payment was earned in the first year after the change:

In fact, the chart of LOSS CORP's "economic activity" shows total "Taxable Income/(Loss)" for the years _____ of (\$ _____ M). "R&D Expense" during this period were only \$ _____ M. A greater portion of the losses arose from a total "Compensation Deduction" of \$ _____ M. Accordingly, TAXPAYER has not established that the LOSS CORP loss is attributable solely to _____ that was included in the Amended CSA.

2. The alleged "license fee" under the " " is not an "arm's-length royalty payment" but a "platform contribution transaction payment," and as such is not attributable solely to the use of the LOSS CORP I/P as of the change date.

In both the PLR request and the PFA request, TAXPAYER makes the following representation:

The description of the Amended CSA and the Buy-In License Agreement at the beginning of this memorandum show that TAXPAYER's representation is not accurate. As indicated above, the alleged "license fee" in the Buy-In License Agreement is based upon an undated report by FIRM A-Tax, with the stated objective of determining a

As described in the regulations under section 482, a "platform contribution transaction" (PCT) payment is made in connection with a "cost sharing arrangement" (CSA).

A "cost sharing arrangement" is an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their reasonably anticipated benefits (RAB) shares. Treas. Reg. § 1.482-7T(b).

In general, a "platform contribution" is any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles. Treas. Reg. § 1.482-7T(c). In other words, a PCT payment is not limited to specific single items but may include any item that is reasonably anticipated to contribute to the cost sharing arrangement.

A platform contribution transaction payment is not the equivalent of a licensing fee. Treas. Reg. § 1.482-7T(c)(4) provides:

- (4) Certain make-or-sell rights excluded — (i) In general. Any right to exploit an existing intangible without further development, such as the right to make, replicate, license or sell existing products, does not constitute a platform contribution to a CSA, and the arm's length compensation for such rights (make-or-sell rights) does not satisfy the compensation obligation under a PCT.

By definition, a PCT payment is not the equivalent of a licensing fee for an existing intangible, because a platform contribution transaction requires "further development" of the intangible. If the payment were made solely for the use of the existing intangible,

without any further modification, it would not qualify as a PCT payment.

The FIRM A-Tax report seems to suggest that items other than the LOSS CORP I/P are included in the valuation:

Accordingly, TAXPAYER has not established that the platform contribution transaction payment is attributable solely to the use of the LOSS CORP I/P as of the change date. We recommend that the audit team should examine what items were specifically contributed to the joint research program. After determining which items were contributed in addition to the LOSS CORP I/P, we recommend that each separate item be valued in order to identify if the \$ million payment corresponds to the value of the lease of the LOSS CORP I/P or some of the other items contributed to the joint research program.

It is our understanding that the examination team is also examining the PCT payment for a possible upward adjustment under section 482, which could substantially increase the \$ million amount that TAXPAYER attributed to the PCT payment. To the extent a section 482 adjustment is made, we need to determine how much of the PCT payment is attributable to the I/P lease and how much is for other items unrelated to the lease. If a section 482 adjustment is made, we would similarly need to discern how much of the adjustment is for the I/P and how much is for other items.

C. Section 382 ISSUES--Determining the part of the I/P lease payment that is not for the consumption of built-in gain within the 5 year recognition period

IRC 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

recognition period is increased by the “recognized built-in gain” (RBIG) for the taxable year, subject to the NUBIG limitation.

Section 382(h)(3)(A) defines NUBIG as follows:

- (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.

There are two rules for RBIG. One rule is set forth in section 382(h)(2), which defines the term “recognized built-in gain,” and a second rule is set forth for “income items” in section 382(h)(6).

Section 382(h)(2). 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)(2) requires a “disposition” in order for gain to be considered recognized built-in gain. In the PFA request TAXPAYER concedes that the license arrangement in this case should not be considered a “disposition” within the meaning of section 382(h)(2):

Section 382(h)(6). Section 382(h)(6)(A) sets forth a special rule for “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.

1. Alleged "Proximity" of Income Item With Pre-Change Period

TAXPAYER first argues that the PCT payment should be treated as an income item that constitutes RBIG by pointing to the 1988 amendment of section 382(h)(6), which changed the language from "accrue on" to "attributable to." TAXPAYER then argues:

TAXPAYER admits that “

We disagree with TAXPAYER's interpretation of the change in the language in section 382(h)(6). The language in section 382(h)(6) was changed in 1988. The legislative history of the 1988 Act does not address why the change was made. However, the three examples provided in the legislative history of section 382(h)(6) concern which period income earned from performing services (not developing an asset as we have in the present case) should be based on when the performance of services and expenses with respect to those services incurred even if income is recognized in a different time period. 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).

Temporary regulations were published in 2007 regarding the treatment of prepaid income under the built-in gain provisions of section 382(h). T.D. 9330. In the preamble to the temporary regulations, the Service noted that certain taxpayers were taking the position that prepaid income received in the period before the change date (pre-change period) but included in gross income in the recognition period is RBIG. Superficially this is similar to the first example in the committee reports, where income is earned in the pre-change period but recognized in the post-change period when cash is received. Certain methods of accounting allow deferral of the prepaid income, which otherwise would be recognized when received under the rules applicable to advance payments. A taxpayer using one of the allowed deferral methods could argue that, like the cash basis

taxpayer in the example, the income "accrued" in the pre-change period but was not recognized until the post-change period.

The temporary regulations rejected that approach. The preamble describes the three examples in the committee reports and then explains:

The IRS and Treasury Department believe that prepaid income is distinguishable from the income items described in the committee report examples. In each of the committee report examples, the item of income is attributable to the pre-change period because that is the period in which performance occurred and expenses were incurred to earn the income. By contrast, prepaid income is attributable to the post-change period because that is the period in which performance occurred and expenses were incurred to earn the income. Therefore, because prepaid income is attributable to the post-change period rather than the pre-change period, the IRS and Treasury Department have determined that such prepaid income should not be treated as RBIG under section 382(h). [Emphasis added.]

The temporary regulations were made final as of June 11, 2010. T.D. 9487 (June 16, 2010). The example in the committee reports dealing with long-term contracts further undercuts TAXPAYER's proximity argument. In the example, the long-term contract was executed during the pre-change period. Arguably, any income subsequently earned under that contract has a proximity to the pre-change period, but only the income actually earned during the pre-change period is considered "attributable to" the pre-change period.

Each cost that was required to develop the LOSS CORP I/P helped create an asset that could be sold in the future. Although TAXPAYER was allowed to expense these costs, the incurred costs are still for developing an asset, not for performing services. The LOSS CORP I/P asset did not generate any income in the pre-change period. It only earned income based on the lease of the I/P in the post-change period. This income, paid in the form of the PCT payment, is not attributable to the pre-change period because it was not earned until the post-change period.

2. "Economic Dispositions"

TAXPAYER also argues that the PCT payment is similar to a sale based on an alleged "economic disposition" of the LOSS CORP I/P.

TAXPAYER asserts that its position results in a "matching" of income and expenses:

It is difficult to demonstrate that any income earned in the post-change period is directly attributable to an expense from a pre-change period. To do so, TAXPAYER would have to trace any income earned from the LOSS CORP I/P directly to expenses incurred in creating the I/P. This tracing methodology would require TAXPAYER to demonstrate that the PCT payment is only for the use of the I/P and that the payment accurately captures the expense of creating the I/P plus some profit margin. TAXPAYER has not presented any facts to support its position. Instead, because tracing is such a difficult exercise, the Service has allowed taxpayers to treat certain income earned from the consumption or wasting of assets as RBIG in Notice 2003-65.

Notice 2003-65 provides "two alternative safe harbors regarding the identification of built-in items under section 382(h) of the Code." These two methods are described as the "1374 approach" and the "338 approach." The Notice emphasizes that "[a]lthough the approaches described in this notice serve as safe harbors, they are not the exclusive methods by which a taxpayer may identify built-in items for purposes of section 382(h). Other methods taxpayers use to identify built-in items for purposes of section 382(h) will be examined on a case-by-case basis." The 338 approach 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 a deemed sale treatment in a hypothetical section 338 election. 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 if in fact, a section 338 election had been made, and with the allowed cost recovery deduction based upon the fair market value basis of the asset on the change date. As such, the 338 approach treats certain built-in gain assets as generating RBIG even if they are not disposed of within the recognition period. TAXPAYER has apparently rejected the safe harbors of Notice 2003-65. But, as noted above, the Notice acknowledges that "other methods" will be evaluated on a case-by-case basis.

The Notice would allow TAXPAYER to use amortization as an approximation of recognized gain, but TAXPAYER has rejected the safe harbors of Notice 2003-65:

In the present case, TAXPAYER has included the LOSS CORP I/P in the Platform Contribution Transaction with FOREIGN SUB. The I/P is being used in the joint research program between TAXPAYER and FOREIGN SUB. Under the 338 approach, TAXPAYER could recognize built-in gain based on the consumption of the I/P in the joint research program. However, TAXPAYER instead argues that the \$ M PCT payment should be treated as RBIG in the year that it contributed the I/P because it economically disposed of the asset in that year, thereby matching the expense of creating the I/P with the payment for the I/P. TAXPAYER's analysis would be correct if the PCT payment was only for the LOSS CORP I/P (and nothing else) and the I/P was fully consumed in that year, but TAXPAYER has not provided facts supporting this position.

In addition, under section 382(h) the "recognition period" for RBIG is five years from the change date. The 338 approach would require a fifteen-year amortization under section 197; thus, only one-third of the allowable amortization would fall within the recognition period. TAXPAYER argues that the entire \$ M PCT payment for use of the I/P was received in one year and must be recognized in that year. TAXPAYER's position is inconsistent with the FIRM A-Tax report which projected anticipated benefits from the LOSS CORP I/P were over a nine year period.

The report acknowledges that the benefit diminishes over time () and a present value computation was made to reduce the future benefits to an up-front payment. The FIRM A-Tax methodology is more consistent with the 338 approach under Notice 2003-65 than is TAXPAYER's position. However, the FIRM A-Tax report incorrectly does not allocate payments over the I/P's whole economic life. In effect, TAXPAYER is "pre-paying" for use of the I/P to bunch the entire \$ M payment into the first year of the five-recognition period instead of allocating it over the nine year economic life.

TAXPAYER's "economic disposition" argument is somewhat similar to the 338 approach, where a "disposition" of an asset may be considered to occur when through use or consumption of the asset, the asset's value depreciates from functional obsolescence or physical depreciation so that at the end of its economic life its value is no more than salvage value. In order for a taxpayer to determine built-in gain without using the assumptions of Notice 2003-65, the taxpayer would have to show that certain

income is from a particular asset and nothing else, that this income represents the using up or consumption of that asset, and that the income does not represent pure rent (the return on investment in excess of cost recovery) or income attributable to an increase in value from market forces.

By taking the view that the PCT payment generates RBIG in the first year of the recognition period, TAXPAYER is essentially taking the position that the LOSS CORP I/P has a 1 year economic life because all the built-in gain should be recognized in that single year. Therefore, we recommend that the audit team determine the economic life of the I/P (in addition to the value of the I/P) and use that amount to determine the amount of built-in gain that should be recognized in each year of the recognition period based on the consumption of the I/P. Some of the value of the I/P may not be consumed within the 5 year recognition period.

D. Litigation Hazards

[REDACTED]

[REDACTED]

[REDACTED]

¹ [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

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

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