Office of Chief Counsel
Internal Revenue Service

memorandum

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date: AUG 04 2000

to: Chief, Appeals Division, Southwest District
Attn: Appeals Officer Joanne Quain

from: District Counsel, Southwest District, Phoenix

ıbject: [redacted]
Substantial understatement penalty

DISCLOSURE STATEMENT

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ISSUE

Whether substantial authority for purposes of I.R.C. § 6662(d) exists for the taxpayer's failure to comply with the provisions of I.R.C. § 338 with respect to acquired contingent liabilities.

CONCLUSION

Substantial authority does not exist for the taxpayer's failure to comply with the requirements of I.R.C. § 338 as to contingent liabilities.

FACTS

Until [redacted], [redacted] ([redacted]) was a subsidiary of the [redacted]. At that point, [redacted] decided to get out of the [redacted] business. [redacted] transferred its [redacted] stock and other [redacted] assets into another wholly owned entity, [redacted] ([redacted]). [redacted] then caused the formation of the taxpayer, [redacted] ([redacted]). The taxpayer then undertook an initial public offering, and used the proceeds to purchase [redacted], which at that point owned all [redacted] stock, from [redacted] in [redacted].

[redacted] elected to treat this transaction as an asset acquisition pursuant to I.R.C. §§ 338(d)(3) and 338(h)(10). At the risk of oversimplification, this section generally allows certain qualifying stock transactions to be treated as asset purchases. This allows, for example, the purchaser to depreciate capital items, whereas the purchaser would not ordinarily be allowed any deduction for amounts paid to purchase stock. As part of such a transaction, the purchase price for the stock must be allocated to the assets of the acquired corporation. Such allocation is important to the workings of § 338; an excessive allocation to items with short lives, for example, would improperly accelerate the amount of the purchaser's claimed deductions for the acquired companies assets.

In the present case, the taxpayer determined its adjusted grossed-up basis (AGUB) by adding in only those liabilities assumed which the taxpayer did not deem contingent, and excluding from AGUB those liabilities deemed contingent. The taxpayer then failed to track the $[redacted] of assumed contingent liabilities, commingling these liabilities in an account with other liabilities. Thus, contrary to Treas. Reg. § 1.338(b)-1, the taxpayer failed to add to AGUB those "contingent" liabilities which became fixed before [redacted], the close of the taxpayer's first taxable year. When such liabilities became fixed, the taxpayer made no effort to adjust AGUB at that point. This resulted in improper immediate deductions when these liabilities were paid, rather than amortization over a period of years if such amount had been properly allocated to intangible assets. The examination team for this case has already undertaken to write a substantial discussion of the incorrect

nature of the taxpayer's basis allocation, and we will not duplicate those efforts in this memorandum. The taxpayer originally indicated that it undertook this method due "to the tremendous accounting burden of identifying exactly when each contingent liability account of every subsidiary became fixed and determinable . . . . It was determined that a more workable approach would be to deduct contingent liabilities when paid." The taxpayer now claims that substantial authority supports its reduction of the purchase price for contingent liabilities and the deduction of such amounts when paid. The taxpayer has proposed to concede the proposed adjustment pursuant to § 338 if the Service does not pursue the penalty proposed for substantial understatement of tax under I.R.C. § 6662. You believe that continued assertion of the penalty is warranted, but have requested our review of this matter.

DISCUSSION

I.R.C. § 6662(a) provides for a penalty equal to 20 percent of any underpayment to which this section applies. Section 6662(b)(2) provides that this section applies to any substantial understatement of income tax. Section 6662(d) defines substantial understatement in relevant part as an understatement of income tax in excess of the greater of $10,000.00 or ten percent of the tax required to be shown on the return. We understand that the taxpayer in this instance would clearly have a substantial understatement if the proposed adjustments in this case are made.

Section 6662(d)(2)(B)(i), however, provides an exception where the taxpayer has or had substantial authority for its disputed treatment of an item. Such authority can include the Internal Revenue Code, regulations construing the Code, court cases, administrative pronouncements such as revenue rulings, revenue procedures or private letter rulings, tax treaties, and congressional intent. Treas. Reg. § 1.6662-4(d)(3)(iii).

In its protest, the taxpayer suggests that Treas. Reg. § 1.338-2(d)(1)(ii) allowed it to adopt any method of accounting meeting the requirements of I.R.C. § 446. The taxpayer further suggests that the Commissioner cannot require a taxpayer to change from an accounting method that clearly reflects income to an alternative method merely because the Commissioner considers the alternative method to more clearly reflect income. The taxpayer also claims that its consideration of the accounting burden is a matter of substantial authority, citing Crane v. Commissioner, 331 U.S. 1 (1947). While these assertions might have some surface appeal, a closer inspection reveals them all to be meritless and/or irrelevant to the problem at hand. (As an

aside, the taxpayer also claims that its method did not result in a significant difference, and should therefore be overlooked. The administrative file reflects the inaccuracy of the taxpayer's numbers supporting such belief).

As for the taxpayer's claim that it may choose any allowable method of accounting under I.R.C. § 446, we acknowledge this as a general rule. The problem with this line of argument is that it totally avoids the true issue in this case, instead using legal platitudes in an attempt to hide what is really at issue. The taxpayer in this case chose to elect to allocate its purchase price of stock to the underlying assets. It nonetheless failed (apparently willingly) to follow the required rules for making such an allocation. The taxpayer therefore has failed to follow its own chosen method of allocating purchase price under § 338. The Service in this case is thus criticizing the taxpayer for its failure to follow the basis allocation procedures which the taxpayer itself chose; it is pointing out that the taxpayer failed to correctly allocate purchase price under the rules set forth in § 338 and its regulations. We therefore agree that the taxpayer may undertake any accounting method it chooses, so long as it is allowable under § 446. The taxpayer nonetheless chose to accept the benefits and burdens of allocating purchase price pursuant to § 338. To carry the taxpayer's argument to the extreme, it believes that it should be able to receive all the benefits of § 338 without following any of its procedures, so long as its chosen method of accounting is otherwise acceptable. Such an interpretation would render meaningless a substantial portion of the regulations under § 338, a result not favored under the principles of construction. When the taxpayer's arguments are reduced to their bare elements, their lack of merit become evident. The taxpayer is claiming that it should be entitled to the benefits of purchase price allocation without being bothered by the need to properly account for contingent liabilities. The taxpayer should not be allowed to complain when the Service notes the taxpayer's failure to comply with the requirements of the provisions it elected.

The taxpayer next complains that the Service cannot change its accounting method merely because the Service considers the alternative to more clearly reflect income. Again, the taxpayer has correctly stated a platitude that has little, if any, relevance to this case. As indicated above, the Service is merely attempting to hold the taxpayer to the procedures which the taxpayer itself elected to follow. To the extent that the Service is changing anything, it is merely correcting the taxpayer's failures to do what it bound itself to do when electing § 338 treatment.

Finally, the taxpayer claims that the substantial accounting burden imposed by the requirements of § 338 is substantial authority for its choice to ignore such requirements, and still otherwise obtain the benefits of that section. The taxpayer cites Crane v. Commissioner, 331 U.S. 1 (1947) for this proposition. We are puzzled by this citation of authority, as we can find nothing in this landmark case to support the proposition that difficulty in complying with required procedures excuses a taxpayer from complying with required procedures. Indeed, in that case, the Court took great pains to correctly determine the meaning of the word "property" as used in the statute and regulations at issue in that case. The Court briefly mentioned as further support for its interpretation of this term the accounting burden that would be placed on all if the Court were to adopt a different definition of "property" than what it believed Congress intended. The taxpayer in the present case is trying to elevate this brief mention of accounting burden when determining legislative intent into a rule that complexity allows a taxpayer to reap the benefits of a provision (§ 338 and underlying regulations) while ignoring the requirements of such provisions. To state it another way, the taxpayer is attempting to distort Crane into a rule that a taxpayer may ignore without penalty any requirement imposed by the code or regulations which places what the taxpayer believes to be excessive burdens on its accounting system. Such assertion is disingenuous and totally unsupported by precedent. To suggest that a taxpayer's accounting resources can dictate whether or not a taxpayer is required to comply with tax provisions does not warrant serious discussion, and does not rise to the level of substantial authority.

To summarize, we believe that the taxpayer is attempting to use platitudes to avoid addressing the true issue in this case, its willing failure to follow the mandates of § 338 and its underlying regulations. The taxpayer wants to excuse its attempt to reap the benefits of § 338 while avoiding its burden through the use of general statements which have little, if any, relevance to the present situation. While we acknowledge the unique hazards in litigating penalties (as opposed to the merits of the case), we believe that the taxpayer's claim of substantial authority lacks merit, and that it is appropriate for the Service to continue pursuing the penalty for substantial understatement of tax.

Please note, we consider the opinions expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel

(Administrative Provisions and Judicial Practice) an opportunity to comment. If you have any questions regarding the above, please contact the undersigned at (602) 207-8052.

DAVID W. OTTO
District Counsel

By: _____
JOHN W. DUNCAN
Attorney

cc: Curt Wilson, Assistant Chief Counsel
(Administrative Provisions and Judicial Practice)