Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:P&SI:7-PLR-114129-00
Date:
January 17, 2001

Legend

Taxpayer:

Parent:

Technology:

Date 1:

Date 2:

Dear

We received a letter from your authorized representatives requesting a ruling that, for purposes of determining gain or loss at the time of sale, the adjusted basis of the property sold includes the unamortized research and experimental expenditures deferred under § 59(e) of the Internal Revenue Code. This letter is in response to that request.

The facts and representations submitted are summarized as follows:

Taxpayer, an accrual basis taxpayer with a calendar year, was acquired by Parent through a taxable acquisition of Taxpayer's stock on Date 1. After the acquisition, Taxpayer had an August 31 tax year.

Taxpayer incurred research and experimental expenditures eligible for expensing under § 174. Taxpayer's research and experimental activities resulted in the development of Technology.

Taxpayer deducted most of its expenditures incurred in developing Technology under § 174(a), however, for its taxable year ending December 31, 1997 and its short taxable year ending on Date 1, Taxpayer elected to defer and amortize all or a portion of its research and experimental expenditures under § 59(e). During its taxable year ending Date 2, Taxpayer sold its rights to Technology to an unrelated purchaser.

In general, § 174 provides two methods of accounting for research or experimental expenditures. Under § 174(a), taxpayers may deduct their research or experimental expenditures in the taxable year in which they are paid or incurred, or they may elect, under § 174(b), to amortize such expenditures over a period of not less than 60 months. Taxpayers not electing to treat research and experimental expenditures under § 174 may continue to capitalize research and experimental expenditures and will continue to receive the same treatment as under pre-1954 law.[1]

In addition to the methods of accounting for research and experimental expenditures under § 174, § 59(e) allows a taxpayer to elect, for regular tax purposes, to capitalize and amortize research and experimental expenditures and other expenditures that may give rise to a minimum tax preference over a 10-year period beginning in the taxable year in which the expenditures were paid or incurred.

Section 59(e) was added to the Code by the Tax Reform Act of 1986. Under § 59(e), any qualified expenditure to which a § 59(e) election applies shall be allowed as a deduction ratably over the ten-year period beginning with the taxable year in which the expenditure was made. Section 59(e)(2) provides that a qualified expenditure includes any amount, but for an election under § 59(e), that would have been allowable as a deduction under § 174(a) for the taxable year in which it was paid or incurred. An election under § 59(e) may be made for any portion of any qualified expenditure. Further, no deduction shall be allowed under any other section for any qualified

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[1]"No specific treatment was authorized by the 1939 Code for research and experimental expenditures. To the extent that they were ordinary and necessary expenses they were deductible; to the extent that they were capital in nature they were to be capitalized and amortized over useful life. Losses in connection with abandoned projects were permitted where amounts had been capitalized, and recovery through amortization was provided where the useful life of these capital items was determinable, as in the case of a patent. Where projects were not abandoned and where a useful life could not be definitely determined the research expenditures could not be amortized." Summary of the New Provisions of the Internal Revenue Code of 1954, Staff of the Joint Committee of Internal Revenue Taxation, February 1955.

expenditure to which an election under § 59(e) applies.

Section 1001 provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1011 provides that the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under § 1012 or other applicable sections of subchapter O and subchapters C, K, and P) adjusted as provided in § 1016.

Except as otherwise provided, § 1012 provides that the basis of property shall be the cost of such property. Section 1016 sets forth the rules for determining adjusted basis. Section 1016(a)(14) requires that proper adjustment to the basis of property shall be made for amounts allowed as deductions as deferred expenses under § 174(b)(1) (relating to research and experimental expenditures) and resulting in a reduction of the taxpayers' taxes but not less than the amounts allowable under § 174(b)(1) for the taxable year and prior years. Section 1016(a)(20) requires that proper adjustment to the basis of property shall be made for amounts allowed as deductions under § 59(e) (relating to optional ten-year writeoff of certain tax preferences).

Section 1.1016-5(j) of the Income Tax Regulations provides that research and experimental expenditures treated as deferred expenses under § 174(b) are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered the "tax-benefit amount allowed" and shall be determined in accordance with § 1.1016-3(e). See also §§ 174(b) and 1.174-4(a)(2) that provide, in part, that amounts treated as deferred expenses are properly chargeable to capital account for purposes of § 1016(a)(1), relating to adjustments to basis of property.

Section 1.1016-6 provides that adjustments must always be made to eliminate double deductions or their equivalent.

For its taxable year ending December 31, 1997 and its short taxable year ending on Date 1, Taxpayer elected to defer and amortize all or a portion of its research and experimental expenditures under § 59(e). Pursuant to § 59(e), Taxpayer began deducting these expenditures ratably over a ten-year period, beginning with the year in which the expenditures were incurred. These research and experimental expenditures and other research and experimental expenditures deducted under § 174(a) resulted in the development of Technology.

During its taxable year ending on Date 2, Taxpayer sold Technology. At the time of the sale, Taxpayer had unamortized research and experimental expenditures deferred under § 59(e). Taxpayer requests a ruling that for purposes of determining gain or loss on the sale of Technology, the adjusted basis of Technology includes the unamortized research and experimental expenditures deferred under § 59(e).

Prior to enactment of § 174, there were no special rules for the tax accounting treatment of research or experimental expenditures. To eliminate uncertainty concerning the treatment of research and experimental expenditures and to encourage taxpayers to perform research and experimentation, the 1954 Code included § 174. In addition to providing rules for the current expense and the deferred methods of treating research and experimental expenditures, the 1954 Code included rules for determining basis of property resulting from research and experimental expenditures. These rules make it clear that expenditures treated as deferred expenses are to be added to the basis of property under § 1016(a)(1) and amounts allowable as deductions as deferred expenses under § 174(b) are subtracted from basis under § 1016(a)(14).

While § 1.1016-5(j) was published prior to the enactment of § 59(e) and thus makes no specific reference to § 59(e), research and experimental expenditures deferred under § 59(e) should be treated in the same manner as research and experimental expenditures deferred under § 174(b) for purposes of determining adjusted basis. Both § 59(e) and § 174(b) provide a means for taxpayers to deduct research and experimental expenditures over a number of years rather than in the year in which the expenditures are paid or incurred. Further, for purposes of making proper adjustments to basis, §§ 1016(a)(14) and section 1016(a)(20) provide the same treatment for research and experimental expenditures deducted ratably under § 174(b) and § 59(e), respectively. Thus, research and experimental expenditures deferred under § 59(e) should be charged to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions that results in a reduction for any taxable year. Accordingly, we conclude that, for purposes of determining gain or loss on the sale of Technology, Taxpayer's the adjusted basis of Technology includes the unamortized research and experimental expenditures deferred under § 59(e).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Further, no opinion is expressed or implied concerning whether amounts Taxpayer treated as research and experimental expenditures eligible for treatment under §§ 174 or 59(e) are research and experimental expenditures within the meaning of § 174.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,
Paul F. Kugler
Associate Chief Counsel
By: Joseph H. Makurath
Senior Technician Reviewer

Enclosure (1)