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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, BOSTON
CC:LM:FSH:BOS
Attention: Barry J. Laterman, Special Litigation Assistant

FROM: Jacob Feldman, Special Counsel, CC:INTL

SUBJECT:

This Field Service Advice responds to your memorandum received October 10, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Acquiring Co =

Amount A	=
Amount B	=
Amount C	=
Amount D	=
Amount E	=
Amount F	=
Amount G	=
Amount H	=
Amount I	=
Amount J	=
Amount K	=
Amount L	=
Amount M	=
Amount N	=
Amount O	=
Amount P	=
Amount Q	=
Amount R	=
Amount S	=
Amount T	=
Amount U	=
Amount V	=
Amount W	=
Amount X	=
Amount Y	=
Amount Z	=
Amount AA	=
Amount BB	=
Amount CC	=
Company X	=
Company Y	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
PR Co	=
Product	=

Taxable Year 1	=
Taxable Year 2	=
Taxable Year 3	=
Taxable Year 4	=
Taxable Year 5	=
Taxable Year 6	=
Taxable Year 7	=
Taxable Year 8	=
Taxable Year 9	=
Taxable Year 10	=
Taxable Year 11	=
Taxable Year 12	=
Taxable Year 13	=
Taxable Year 14	=
Taxable Year 15	=
Taxpayer Representative	=
US Co	=
Year 1	=
Year 2	=

ISSUES:

1. Whether the cost sharing payments made by PR Co pursuant to (a) the Date 1 Cost Sharing Agreement (in Taxable Years 1 and 2) and (b) the cost sharing method of section 936(h)(5)(C)(i) (in Taxable Years 3 through 6) are "research and experimental expenditures" as defined for purposes of section 174. How should these cost sharing payments be characterized?

2. Whether or not PR Co was properly entitled to amortize its cost sharing payments, made to US Co under the Date 1 Cost Sharing Agreement and the cost sharing method of section 936(h)(5)(C)(i), under section 174 or some other provision, what are the tax consequences of ceasing to amortize such payments, as PR Co did in Taxable Year 7 when it elected to switch to the profit split method? Did suspending such amortization deductions constitute a change in method of accounting, notwithstanding the taxpayer's failure to seek consent to change accounting method? If suspending these amortization deductions constituted a change in accounting method, what is the effect of the change?

CONCLUSIONS:

1. Given the definition of R&E expenditures contained in Treas. Reg. § 1.174-2, it was not appropriate for PR Co to treat payments made pursuant to (a) the

Date 1 Cost Sharing Agreement and (b) the cost sharing method of section 936(h)(5)(C)(i) as R&E expenditures eligible for section 174 treatment. Payments made pursuant to the Date 1 Cost Sharing Agreement are not section 174 R&E expenditures but rather payments for the right to use the patents, models, productions, processes, or other manufacturing intangibles of US Co. It additionally appears that the "engineering expense" shared under the Date 1 CSA may have included items that are not R&E expenditures eligible for the special treatment of section 174. A section 936(h) CSM payment is properly characterized as consideration for pre-existing manufacturing intangible assets, i.e., the equivalent of a royalty payment. The definition of product area research expenditures contained in section 936(h)(5)(C)(i)(I)(a) also includes expenditures that are not R&E expenditures as the term is defined in Treas. Reg. § 1.174-2. Accordingly, payments made pursuant to the cost sharing method of section 936(h)(5)(C)(i) are not an R&E expenditure as that term is defined in Treas. Reg. § 1.174-2.

2. In Taxable Year 7, the year in which PR Co elected to switch from the cost sharing method to the profit split method, PR Co made an unauthorized change in its method of accounting for the cost sharing payments made to US Co under the Date 1 Cost Sharing Agreement (in Taxable Years 1 and 2) and under the cost sharing method of section 936(h)(5)(C)(i) (in Taxable Years 3 through 6). PR Co should have taken a negative section 481(a) adjustment for the unamortized portion of these payments in Taxable Year 7, the year in which it made the unauthorized change in method of accounting. PR Co failed to take the section 481(a) adjustment in Taxable Year 7 and did not request the Commissioner's permission to take the adjustment into account in a different year or years. PR Co (and US Co) thus lost the ability, if otherwise proper (but see Conclusion 1 above), to deduct this amount in any form in subsequent taxable years. Accordingly, in the taxable years at issue (Taxable Years 13 through 15), US Co may not claim any deductions attributable to cost sharing payments made in Taxable Years 1 through 6.

<u>FACTS</u>:

General Background

In the three taxable years at issue — Taxable Years 13 through 15 — US Co has claimed $ Amount A in amortization deductions carried over from its wholly-owned subsidiary, PR Co. The amortization deductions, claimed in connection with what US Co has characterized as section 174 research and experimental (R&E) expenditures, were generated as a result of cost sharing payments made by PR Co to US Co in years in which PR Co had elected to be treated as a possessions corporation under section 936. US Co has represented that PR Co elected to amortize the amount of each annual cost sharing payment over a ten-year period under section 174, rather than take a current deduction.

After its incorporation in Year 1, PR Co entered into agreements to share research costs and benefits with US Co and certain other affiliated companies. These agreements are not presently available for inspection, and their terms can only be inferred from other available documentation, such as the Cost Sharing Agreement of Date 1 ("Date 1 CSA"), which replaced them. The Date 1 CSA indicates that PR Co had entered into separate cost sharing agreements with US Co, Company X, and Company Y, as well as a Cost Sharing Agreement of Date 2 ("Date 2 CSA"), which was jointly executed by US Co, Company X, and Company Y. The Date 1 CSA indicates that, pursuant to these earlier agreements, US Co, PR Co, Company X, and Company Y had shared both "the costs and results of the development" of Product and the "manufacturing and production information relating thereto."[1]

In the year of the Date 2 CSA, PR Co apparently began to amortize what it termed "research and development" costs over 10 years (120 months). PR Co treated the cost sharing payments it made under that agreement (and under any other similar agreements) as R&E expenditures subject to such amortization under section 174.

The Date 1 CSA Years (Taxable Years 1 and 2)

On Date 1 (a date during Taxable Year 1), US Co, PR Co, Company X, and Company Y jointly executed the Date 1 CSA. Under its terms, the parties purported to share ratably in the joint costs of research and development. More precisely, the parties agreed to share their total "corporate engineering expense," which was loosely defined as "engineering expense."[2] The total corporate engineering expense was allocated among the parties based upon the ratio of an individual party's sales to the total sales of all parties, as adjusted for certain sales transactions among the parties. If a party were allocated more corporate engineering expense than it had incurred, the party made a cost sharing payment to reimburse the others. If a party were allocated less corporate engineering expense than it had incurred, the party received reimbursement.

Under the Date 1 CSA, each party had free access to the finished intangibles held by the other parties, and had the exclusive right to exploit such intangibles within its assigned geographic area. Each party also had similar access and rights with respect to intangibles that would subsequently result from current corporate engineering expense, provided it remained a party to the agreement. The Date 1 CSA generally provided that the party whose employees, agents, or servants developed any intangible owned that intangible. The parties agreed, however, that US Co was to be assigned all copyrights on software developed by the other parties. We assume that US Co personnel conducted the relevant intangible

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[1] See Date 1 CSA, pp. 1, 2, 21.

[2] See Date 1 CSA, p. 4.

development, so that US Co, not PR Co, was the owner of all relevant intangibles in accordance with these provisions of the Date 1 CSA.

The Date 1 CSA was to be automatically renewed from year to year but could be terminated upon any party's breach of a material term of the agreement or upon certain other extraordinary events (e.g., a party's bankruptcy or insolvency, or government proceedings under eminent domain). Failure by PR Co to make the Date 1 CSA payments would have constituted a material breach, triggering the termination provisions. Upon such termination, the relevant party lost all rights accrued in the period preceding termination to use the intangibles held by the other parties; in certain circumstances, this party also surrendered all ownership rights in its own intangibles to US Co. Since we assume that US Co was the owner of all relevant intangibles in accordance with the provisions of the Date 1 CSA discussed in the preceding paragraph, any default of PR Co's rights under the termination provisions would be to US Co, not PR Co. Accordingly, a termination would not involve any buy-out or other consideration to PR Co on account of any rights under the Date 1 CSA.

In Taxable Year 1 and thereafter, the corporate engineering expense incurred by PR Co (if any) was substantially less than its allocated share of total corporate engineering expense under the Date 1 CSA. Accordingly, PR Co was liable for a cost sharing payment in every year covered by the Date 1 CSA. PR Co treated these cost sharing payments as R&E expenditures and amortized them over ten years under section 174.

Cost Sharing Method Years (Taxable Years 3 through 6)

In Taxable Year 3, PR Co elected to use the cost sharing method ("CSM") of section 936(h)(5)(C)(i). Under the CSM, PR Co was required to make a cost sharing payment to US Co for its share of the "product area research" expenditures — broadly, the research and development expenses of the US Co affiliated group with respect to products of the type manufactured by PR Co. This cost sharing payment (the "section 936(h) CSM payment") was deductible by PR Co, which reduced its income and thus its possessions corporation tax credit under section 936.

Consistent with PR Co's election of the CSM, the Date 1 CSA was amended to provide that the obligations of PR Co thereunder would be deemed satisfied by "the payment of the amount calculated under Section 936(h)(5)(C)(i) of the Internal Revenue code" (i.e., the section 936(h) CSM payment). The amendment notes — and adds to the preamble of the Date 1 CSA — that CSM taxpayers are required by statute to make the section 936(h) CSM payment and that "no credit will be given for payments pursuant to any other agreement." The amendment is not dated but provides that it is effective for Taxable Year 3 and subsequent taxable years.

In the years in which it elected the CSM, PR Co appears to have made payments to US Co in amounts equal to the section 936(h) CSM payment. Pursuant to the amended Date 1 CSA, US Co treated these payments as satisfying PR Co's obligations under both section 936(h) and the Date 1 CSA. It is not known whether the cost sharing payment under the original formula of the Date 1 CSA would have been higher than the section 936(h) CSM payment in any of these years.

During the CSM years, PR Co appears to have treated the section 936(h) CSM payments as section 174 R&E costs and amortized them over 10 years. In these years, PR Co reported "Net cost sharing amounts" on the Schedules P (on line 7 of Part I) attached to its Forms 5735, but left blank line 7(a) ("Cost sharing amount") of Part II of its Forms 5735.[3] PR Co instead reported a "Research & Development" amortization amount as part of the "Definitely allocable deductions" on line 7(b) of Part II of Form 5735. In Taxable Years 3 and 4, PR Co itemized its line 7(b) "Definitely allocable deductions," reporting $ Amount B (for Taxable Year 3)[4] and $ Amount C (for Taxable Year 4)[5] for "Research & Development." We do not have an itemization of PR Co's "Definitely allocable deductions" for Taxable Years 5 and 6, but the line 7(b) amount is equal to the Form 4562 R&D amortization amount in Taxable Year 6 and close to the Form 4562 R&D amortization amount in Taxable Year 5.[6]

Profit Split Method Years (Taxable Years 7 though 10)

Effective Taxable Year 7, PR Co elected to switch from the CSM to the profit split method ("PSM"). PR Co remained on the PSM through Taxable Year 10. PR Co

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[3] The instructions for line 7(a) of Part II of Form 5735 state: "Include the sum of all cost sharing amounts entered on line 7 of Part I of Schedule(s) P if the cost sharing method applies." Similarly, line 7 of Part I of Schedule P states: "If the cost sharing method applies, also include [the "Net cost sharing amount"] on line 7(a) of Part II of Form 5735 and on line 26, page 1, Form 1120 of the possessions corporation."

[4] In Taxable Year 3, PR Co reported R&D amortization in the amount of $ Amount B on Form 4562; this same amount was included for R&D amortization in the "Other deductions" reported on line 26 of Form 1120.

[5] In Taxable Year 4, PR Co reported R&D amortization in the amount of $ Amount D on Form 4562; $ Amount C was included for R&D amortization in the "Other deductions" reported on line 26 of PR Co's Form 1120. The difference between $ Amount C and $ Amount D is immaterial.

[6] In Taxable Year 6, line 7(b) "Definitely allocable deductions" and the Form 4562 R&D amortization amount were both $ Amount E. In Taxable Year 5, line 7(b) "Definitely allocable deductions" were $ Amount F and the Form 4562 R&D amortization amount was $ Amount G.

made cost sharing payments during the PSM years, which it deducted in full each year as “R&D Expense (Profit Split Method).” In the PSM years, PR Co stopped taking deductions for amortization of earlier years’ R&D costs and maintained an amortization schedule (which included the PSM years’ R&D expenses) on a memorandum account basis.

The treatment of R&D during the PSM years is not entirely clear. Research and development amounts appear at three points in PR Co’s income tax returns for the PSM years. R&D expenses are included in the “Other deductions” amount on line 26 of Form 1120[7] and, presumably, in the “Definitely allocable deductions” on line 7b of Part II of Form 5735.[8] In Taxable Years 9 and 10, it appears that deductions for items in addition to R&D were included in the line 7b “Definitely allocable deductions” (we do not have an itemization); in Taxable Year 9, line 7b does not match (i.e., is greater than) the line 26 R&D expense deduction on Form 1120.[9] The third appearance of R&D in these returns is on line 4c of Part II of the Schedules P (“Research and development expenses”). This amount is equal or close to the amount used in the Form 1120 calculation in some years (Taxable Years 7 and 9), but not in Taxable Year 8.[10]

The R&D expenses deducted by PR Co (on line 26 of Form 1120) in Taxable Years 7, 8, and 9 were $ Amount H, $ Amount I, and $ Amount J, respectively.[11] The PSM does not require cost sharing payments. According to US Co, however, PR Co made cost sharing payments to US Co in Taxable Years 7, 8, and 9 that approximated the line 26 deduction amounts, after adjustment for manufacturing

[7] “R&D Expense (Profit Split Method)” is included in the itemization of PR Co’s line 26 “Other deductions” for Taxable Years 7, 8, and 9. Our copy of PR Co’s Taxable Year 10 return does not include an itemization of “Other deductions.”

[8] In Taxable Years 7 and 8, the amount of PR Co’s line 26 R&D deduction is the same as the “Definitely allocable deduction” amount on Form 5735.

[9] As noted, we do not have an itemization of PR Co’s “Other deductions” for Taxable Year 10.

[10] We additionally note that PR Co appears to have entered the incorrect amount on line 4d of Part II on a number of its Schedules P. The line 4d amount (the greater of line 4b or 4c) serves as floor for the R&D deductions used in the computation of combined taxable income.

[11] US Co provided more information regarding its tax returns for the PSM years in an undated response to an IDR (entitled “Information Document Request, INT’L — 004, dated [Date 4]. Subject: [PR Co] PROFIT SPLIT RETURNS”). In this response, US Co noted, without explanation, that “[i]nformation for [Taxable Year 10] is not available.”

projects.[12] US Co presented the following reconciliation of PR Co's PSM year R&D payments with the line 26 deduction amounts:[13]

		Taxable Year 7	Taxable Year 8	Taxable Year 9
	"482 Cost Sharing Transfer Price"[14]	Amount L	Amount M	Amount N
	"Actual Cash Payment (110% of Transfer Price)"	Amount O[15]	Amount P	Amount Q
	"Less: Mfg. Projects"	(Amount R)	(Amount S)	(Amount T)
A	"Current R&D per Amort. Sch."	Amount U	Amount V	Amount W
B	"R&D — Form 1120, line 26"	Amount H	Amount I	Amount J
	"Difference" (**B - A**)	Amount K	Amount X	(Amount Y)

US Co has stated that the line 26 R&D expense deductions in the PSM years "approximate PR Co's current year R&D expenditures."[16] This statement begs the question of how exactly PR Co's R&D expenses were calculated in these years, since these "expenditures" are essentially a legal/accounting creation that is determined under a particular set of rules. Given the number of inconsistencies and calculation errors in PR Co's returns for the PSM years[17] — as well as the absence of an itemization of PR Co's Taxable Year 10 "Other deductions" — it is difficult to characterize how PR Co determined the amounts deducted on line 26.

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[12] See the IDR response cited supra note 11. The differences do not appear to be material, except in Taxable Year 7, when the line 26 amount was $ Amount K in excess of the actual payment. US Co has "not been able to determine why there is a difference of this amount."

[13] See id.

[14] There is an insignificant difference between these amounts and the sum of the "Cost sharing amounts" reported on line 7 of Part I of the relevant years' Schedules P.

[15] US Co appears to have made an error in calculating this amount: 110 percent of Amount L is Amount Z.

[16] This statement is contained in an undated follow-up to the IDR response cited supra note 11 (entitled "Information Document Request, INT'L — 004, dated [Date 4]. Subject: [PR Co] PROFIT SPLIT RETURNS. Response to question #7: Review of the Draft Statement of Facts prepared by the IRS").

[17] As noted above, for example, in Taxable Years 7, 9, and 10, PR Co did not enter the correct amount ("the greater of line 4(b) and 4(c)") on line 4(d) of several of its Schedules P.

In Taxable Year 7, the line 26 amount most closely approximates 120 percent of the sum of the Schedule P CSM amounts. During the PSM years, 120 percent of the CSM amount served as a floor on R&D expenses in making the combined taxable income (CTI) calculation. See I.R.C. § 936(h)(5)(C)(ii)(II).

In Taxable Years 8 and 9, the line 26 amount most closely approximates 110 percent of the Schedule P CSM amounts. During the PSM years, 110 percent of the CSM amount served as a floor on a CSM taxpayer's share of product area research (i.e., the section 936(h) CSM payment).[18] See I.R.C. § 936(h)(5)(C)(i)(I).

It seems clear, however, that the line 26 R&D expense deductions do not represent amortization of R&D. No amortization was reported on PR Co's Forms 4562 for Taxable Years 7 through 9,[19] nor do the line 26 R&D expense deductions approximate the relevant years' "memorandum account" amortization amounts from PR Co's amortization schedule. Taxpayer Representative also states that, for Taxable Years 7 through 10 (i.e., the PSM years), "[t]here were no additional deductions claimed for amortization of previously incurred R&E expenditures (i.e., for unamortized amounts arising in years prior to [Taxable Year 7])."[20]

US Co states that, except for Taxable Year 7, the line 26 R&D expense deductions "agree within approximate amounts to the amortization schedule" (i.e., the current year R&D expense, however calculated).[21]

In conclusion, it is difficult to say with certainty what exactly PR Co deducted to reflect its use of intangibles during the PSM years, or how this amount was calculated. However the current year R&D expense was calculated, PR Co appears to have deducted the entire amount in each PSM year, rather than amortizing it over 10 years. During the PSM years it also appears that PR Co did not take into account any amortization of R&D amounts accumulated in the Date 1 CSA and CSM years.

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[18] These circumstances suggest that PR Co applied an incorrect floor on R&D expenses in its CTI calculations for these years. This advice, however, does not express an opinion on the accuracy of the PSM year CTI calculations.

[19] We were not provided with a Form 4562 for Taxable Year 10.

[20] See the undated memorandum prepared by Taxpayer Representative entitled "Memorandum Discussing [Acquiring Co's] Position Regarding R&E Amortization Arising from [PR Co]."

[21] See the IDR response cited supra note 16. As noted above, US Co stated it was unable to determine the reason for the difference in Taxable Year 7. We also note that we could not evaluate the accuracy of this statement with respect to Taxable Year 10 without an itemization of that year's line 26 deductions.

Taxable Year 11 and Subsequent Years

Effective the first day of Taxable Year 11, PR Co elected out of section 936 and joined the US Co consolidated group. Taxpayer Representative states:

> For [Taxable Year 11] through [Taxable Year 14], [PR Co] continued to deduct its previously unamortized R&E expenditures.
>
> In [Taxable Years 11 and 12], [PR Co] incurred R&E expenses totaling $ [Amount CC] (with [US Co] recording the corresponding income relative to these cost sharing charges). Consistent with [PR Co's] established tax accounting method, these amounts were capitalized and amortized over 10 years.[22]

PR Co did not make any cost sharing payments to US Co in Taxable Years 13 through 15, according to its amortization schedule. In Taxable Years 11 though 14, PR Co appears to have claimed amortization deductions for (i) the "unamortized" portion of cost sharing payments made in the Date 1 CSA, CSM, and PSM years and (ii) the "cost sharing charges" paid in Taxable Years 11 and 12. A comparison of US Co's line 26 deductions in these years — which include, under various labels,[23] amounts for PR Co R&D — with PR Co's amortization schedule appears to confirm that these deductions do in fact represent amortization. The relevant line 26 deduction amounts are equal to the current taxable year amortization schedule amounts in Taxable Years 14 and 15; these amounts differ by one dollar in Taxable Years 11 and 13, and by an amount we do not consider significant ($ Amount AA) in Taxable Year 12.

It is important to note, however, that the amortization schedule appears to include R&D amounts for the PSM years and thus does not reflect PR Co's choice to expense, rather than capitalize, current PSM year R&D expenses. As a result, to the extent the relevant line 26 deduction amounts were determined using the amortization schedule, US Co would appear to have (improperly) deducted the same PSM year R&D expenses twice: once, in full, in the years "incurred" (Taxable Years 7 through 10); and again, in Taxable Year 11 and subsequent taxable years, over the remaining portion of the relevant 10-year amortization period. Through the inclusion of PSM year R&D expenses in the amortization schedule, US Co appears

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[22] See the memorandum cited supra note 20.

[23] In Taxable Years 11 and 12, these amounts appear as "Research and Development" in the itemization of PR Co deductions. In Taxable Years 13 and 14, these amounts appear as "Amortization – in service prior year" in the itemization of PR Co deductions. In Taxable Year 15, this amount appears as "Amortization of Puerto Rican R&D" in the itemization of US Co deductions.

to have overstated its deduction for amortization of PR Co R&D by $ Amount BB in each of Taxable Years 11 through 15.

PR Co was liquidated into US Co on Date 3 (a date near the end of Taxable Year 14). Taxpayer Representative states that "[a]s successor in interest to [PR Co's] tax attributes, [US Co] continued to amortize the remaining [PR Co] capitalized R&D expenditures."[24]

US Co was acquired by Acquiring Co in Year 2.

LAW AND ANALYSIS

Section 936

Section 936 provides a qualified possessions corporation[25] a credit against the United States income tax attributable to non-U.S. source taxable income from the active conduct of a trade or business within a possession of the United States (or the sale or exchange of substantially all the assets used by the taxpayer in the active conduct of such trade or business) and "qualified possession source investment income." I.R.C. § 936(a)(1).[26] Special rules apply, however, to a possessions corporation's income that is attributable to intangible property. Section 936(h) provides that the intangible property income of a corporation electing the application of section 936 shall be included on a pro rata basis in the gross income of its U.S. shareholders as U.S.-source income unless the possessions corporation elects one of two methods for allocating intangible property income between the possessions corporation and its U.S. affiliate(s): the cost sharing method or the

[24] See the memorandum cited supra note 20.

[25] A qualified possessions corporation must: (1) be incorporated in the United States; (2) have derived at least 75% of its gross income from the active conduct of a trade or business within Puerto Rico or another U.S. possession in the 3 years preceding the close of the taxable year; (3) have derived at least 80% of its gross income from sources within a possession of the United States for that same 3-year period; and (4) elect possessions corporation status. See I.R.C. § 936(a).

[26] The Small Business Job Protection Act of 1996 (P.L. 104-188) terminated the Puerto Rico and possession tax credit for tax years beginning after December 31, 1995. See I.R.C. § 936(j). Special phase-out rules apply to existing credit claimants' "active business income."

profit split method.[27] Once made, an election to use the cost sharing method or the profit split method may not be revoked without consent. I.R.C. § 936(h)(5)(F)(iii).

The Cost Sharing Method (CSM)

A section 936 corporation that elects the cost sharing method must make a payment, generally to the parent of the U.S. consolidated group, for its share of the affiliated group's "product area research" expenditures. I.R.C. § 936(h)(5)(C)(i)(I). "Product area research" expenditures include:

- R&E expenses deductible under section 174;
- Qualified research expenses under section 30(b);
- Payments such as royalties for the right to use a patent, invention, formula, process, design, pattern, or know-how; and
- A proper allowance for amounts incurred in the acquisition of depreciable or amortizable manufacturing intangible property.

See I.R.C. § 936(h)(5)(C)(i)(I)(a). The possessions corporation's share of product area research expenditures is determined by the proportion of the possessions corporation's third-party sales (in the relevant product area) to the total third-party sales (in the relevant product area) by all members of the affiliated group. For tax years beginning after December 31, 1986, the CSM payment amount shall not be less than 110 percent of this proportion of product area research expenditures, nor shall it be less than the inclusion or payment that would be required under section 367(d)(2)(A)(ii) or section 482 if the section 936 corporation were a foreign corporation (sometimes referred to as the "commensurate-with-income" floor). I.R.C. § 936(h)(5)(C)(i)(I).

The CSM payment does not constitute taxable income to the recipient, but rather reduces the deductions, and the amount of reductions in earnings and profits, otherwise allowable to the appropriate domestic member(s) of the affiliated group. I.R.C. § 936(h)(5)(C)(i)(IV)(a). The regulations provide the following explanation:

> *Question 1:* What is the effect of the cost sharing method?
>
> *Answer 1:* The cost sharing payment reduces the amount of deductions (and the amount of reductions in earnings and profits) otherwise allowable to the U.S. affiliates (other than tax-exempt

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[27] Section 936(h) was enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982. Through this provision, Congress intended to ensure taxation of at least a portion of the income derived from intangible property transferred tax-free from U.S. corporations to their affiliated possessions corporations. See Joint Committee on Taxation Staff, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, 97th Cong., 2d Sess. (1982).

> affiliates) within the affiliated group . . . . With respect to each [affiliated] group above, the reduction of deductions shall be applied first to deductions under section 174, then to deductions under section 162, and finally to any other deductions on a pro rata basis.

Treas. Reg. § 1.936-6(a)(5), Q&A 1.

Notice 88-123, 1988-2 C.B. 458 (the "Section 482 White Paper") focuses primarily on cost sharing under section 482, but it also discusses the nature of CSM payments. The Section 482 White Paper states:

> The cost sharing payment made by a possessions corporation pursuant to the special cost sharing election under section 936(h)(5)[(C)(i)](I) must be determined under those rules and not under a contractual cost sharing arrangement that would otherwise govern the charges incurred by the participants. Indeed, the statute and regulations explicitly provide that the section 936(h) cost sharing payment shall not be reduced by a contractual cost sharing payment. . . .
>
> . . . . .
>
> The amount paid under section 936(h) entitles the possessions corporation to be treated as the owner of manufacturing intangibles <u>previously developed</u> by its U.S. affiliates. The fact that a possessions corporation has entered into a cost sharing arrangement for the development of <u>future</u> intangibles and is paying a lesser amount under that arrangement does not affect the amount required under the section 936(h) cost sharing election. Indeed, since <u>the section 936(h) cost sharing payment is compensation for intangibles previously developed</u> and the section 482 cost sharing payment made pursuant to the contractual cost sharing agreement is for the cost of developing new intangibles, both amounts appropriately must be paid initially — one by statutory election and the second pursuant to the contractual arrangement. It might be argued that, once intangibles are developed under the section 482 cost sharing arrangement, the possessions corporation's section 936 cost sharing payment should be reduced so that the possessions corporation does not pay a second time for that intangible. The statute, however, precludes that result.

1988-2 C.B. at 498 (citations omitted) (emphasis added).

The statute provides that, "[f]or purposes of determining the <u>amount of its gross income</u> derived from the active conduct of a trade or business in a possession with respect to a product produced by, or type of service rendered by, the electing corporation," a corporation validly electing the CSM shall be treated as "the owner (for purposes of obtaining a return thereon)" of manufacturing intangibles. I.R.C. § 936(h)(5)(C)(i)(II) (emphasis added). Given the language of the statute, such treatment does not apply for other purposes, such as the character of the section 936(h) CSM payments, which must be determined under generally applicable principles.

Where an electing corporation fails to make timely payment of all or part of the section 936 CSM payment, the amount of the payment required to be paid shall be increased by the amount of interest that would have been due under section 6601(a) had the unpaid portion of the payment been an amount of tax. The amount by which a section 936(h) CSM is so increased "shall not be treated as a cost sharing payment or as interest." Where failure to make timely payment is due in whole or in part to fraud or willful neglect, the electing corporation shall be deemed to have revoked its election. I.R.C. § 936(h)(5)(C)(i)(III).

The Profit Split Method (PSM)

The profit split method is the other election available to prevent the attribution of a section 936 corporation's intangible property income to its U.S. shareholders. See I.R.C. § 936(h)(5)(C)(ii). The PSM begins with a computation of the combined taxable income (CTI) of the affiliated group from "covered sales"[28] of possession products. See I.R.C. § 936(h)(5)(C)(ii)(II). Once CTI is determined, 50 percent is allocated to the section 936 corporation. CTI, computed without regard to the last sentence of section 936(h)(5)(C)(ii)(II),[29] less the amount allocated to the section 936 corporation, is allocated to the appropriate U.S. affiliate(s). Under the PSM, no cost sharing payment is required, and even if it continues to be made there is no tax effect.

CTI is computed for each product produced or type of service rendered by the electing possessions corporation. CTI is determined:

> by deducting from the gross income of the affiliated group (other than foreign affiliates) derived from covered sales of such product or type of service all expenses, losses, and other deductions properly apportioned or allocated to gross income from such sales or services, and a ratable part of all expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income, which are incurred by the affiliated group (other than foreign affiliates).

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[28] See I.R.C. § 936(h)(5)(C)(ii)(IV).

[29] The last sentence of section 936(h)(5)(C)(ii)(II) provides for a floor on the R&D costs allocated to the gross income of the affiliated group (other than foreign affiliates) derived from covered sales.

> Notwithstanding any other provision to the contrary, in computing the combined taxable income for each such product or type of service rendered, the research, development, and experimental costs, expenses, and related deductions for the taxable year which would otherwise be apportioned or allocated to the gross income of the affiliated group (other than foreign affiliates) derived from covered sales of such product produced or type of service rendered, in whole or in part, by the electing corporation in a possession, shall not be less than the same proportion of the amount of the share of product area research determined under subparagraph (C)(i)(I) (without regard to the third and fourth sentences thereof, by substituting "120 percent" for "110 percent" in the second sentence thereof) in the product area which includes such product or type of service, that such gross income from the product or type of service bears to such gross income from all products and types of services, within such product area, produced or rendered, in whole or in part, by the electing corporation in a possession.

I.R.C. § 936(h)(5)(C)(ii)(II). In sum, in computing CTI, the cost sharing payment that would have been required under the CSM (calculated by substituting "120 percent" for "110 percent," and without regard to the commensurate-with-income floor) serves as a floor for the R&D deduction.

Election of the CSM or PSM

Generally, an election to use either the CSM or PSM must be made on or before the due date prescribed by law (including extensions) for filing the tax return of the electing corporation for its first taxable year after December 31, 1982. An election to use either the CSM or PSM is binding on the electing corporation and may be revoked by the electing corporation only with the consent of the Secretary. Under certain circumstances, however, the electing corporation will be deemed to have revoked its election. See I.R.C. § 936(h)(5)(F)(iii).

Section 174

Treatment of R&E expenditures under section 174

Under section 174, taxpayers may use one of two methods of accounting for R&E expenditures. Taxpayers may deduct their R&E expenditures in the tax year in which they are paid or incurred, or they may elect to amortize R&E expenditures over a period of not less than 60 months. I.R.C. § 174(a) and (b); Treas. Reg. § 1.174-1. Absent an election under section 174, R&E expenditures must be charged to capital account. Treas. Reg. § 1.174-1.

The election to treat R&E expenditures as deferred expenses under section 174(b) applies only to those expenditures which are chargeable to capital account but not chargeable to property of a character subject to the allowance under section 167 (relating to the allowance for depreciation) or section 611 (relating to the allowance for depletion). Thus, the election under section 174(b) applies only if the property resulting from the R&E expenditures has no determinable useful life. If the property resulting from the expenditures has a determinable useful life, section 174(b) is not applicable, and the capitalized expenditures must be amortized or depreciated over the determinable useful life. Amounts treated as deferred expenses are properly chargeable to capital account for purposes of section 1016(a)(1), relating to adjustments to basis of property. Further, if expenditures that the taxpayer has elected to defer and deduct ratably over a period of time in accordance with section 174(b) result in the development of depreciable property, deductions for the unrecovered expenditures, beginning with the time the asset becomes depreciable in character, shall be determined under section 167 (relating to depreciation) and the regulations thereunder. Treas. Reg. § 1.174-4(a)(2) and (4).

In addition to the methods of accounting for R&E expenditures under section 174, section 59(e)(1) allows a taxpayer with section 174(a) R&E expenditures to elect to capitalize and amortize R&E expenditures over a 10-year period beginning in the taxable year in which the expenditure was paid or incurred. I.R.C. § 59(e)(2). Further, the section 59(e)(1) election can be made with respect to any portion of any qualified expenditure. I.R.C. § 59(e)(4)(A). The legislative history of the section indicates that an election under section 59(e) can be made “dollar for dollar.” H.R. Rep. 99-426, 99th Cong., 1st Sess. 327 (1986), 1986-3 (Vol. 2) C.B. 1, 327.

A taxpayer may adopt the current expense method or the deferred expense method without the consent of the Secretary for the taxpayer’s first tax year for which R&E expenditures are paid or incurred. The election to treat R&E expenditures as current expenses is made by deducting the expenses on the tax return for the year in which the expenses were paid or incurred. The election to treat R&E expenditures as deferred expenses is made by attaching a statement to the taxpayer’s return for the first taxable year to which the election is applicable. Treas. Reg. §§ 1.174-3(b)(1), 1.174-4(b)(1). See also Rev. Rul. 76-324, 1976-2 C.B. 77.

A taxpayer may, with the consent of the Commissioner, adopt the current expense method at any time. When adopted with consent, the method shall apply only to expenditures incurred during the tax year for which the request to adopt the current expense method is made and to expenditures paid or incurred in subsequent years. Treas. Reg. § 1.174-3(b)(2).

The election to treat R&E expenditures as deferred expenses must be made not later than the time prescribed by law for filing the return for the taxable year (including extensions) for which the deferred expense method is to be adopted. If the taxpayer has adopted the current expense method for R&E expenditures, the taxpayer may not elect to defer and amortize any R&E expenditures unless permission to do so is granted. Treas. Reg. § 1.174-4(b)(1) and (2).

If the current expense method is adopted under section 174(a), that method shall apply to all expenditures described in section 174(a) and must be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless the Commissioner authorizes a change to a different method with respect to part or all of these expenditures. Treas. Reg. § 1.174-3(a). Similarly, if the deferred expense method is elected under section 174(b), the taxpayer must adhere to that method and amortization period in computing taxable income for the taxable year of the election and for all subsequent taxable years unless a change to a different method (or to a different period) is authorized with respect to part or all of this expenditure.

A taxpayer may file an application for permission to change to a different method of treating R&E expenditures. All of the information listed in Treas. Reg. § 1.174-3(b)(3) must be included in the application. A change of method can be requested for a taxpayer's R&E expenditures on a project by project basis. In addition, a taxpayer may file an application for permission to change to a different amortization period for deferred expenses. The application must include the information required by Treas. Reg. § 1.174-4(b)(2). A valid deferred expense election may not be revoked by filing an amended return. Rev. Rul. 83-138, 1983-2 C.B. 50.

Section 1016(a)(14) and (20) provides that proper adjustment in respect of the property shall in all cases be made for amounts allowed as deductions as deferred expenses under section 174(b)(1) and resulting in a reduction of the taxpayer's taxes, but not less than the amounts allowable under section 174(b) for the taxable year and prior years, and for amounts allowed as deductions under section 59(e).

Expenditures eligible for section 174 treatment

Expenditures eligible for the special treatment of section 174 must be R&E expenditures as defined in Treas. Reg. § 1.174-2(a). The current version of Treas. Reg. § 1.174-2(a) (hereinafter "Treas. Reg. § 1.174-2(a) (1994)") applies to taxable years beginning after October 3, 1994, and therefore did not apply to the Date 1 CSA years (Taxable Years 1 and 2) nor to the CSM years (Taxable Years 3 through 6). <u>See</u> Treas. Reg. § 1.174-2(a)(7) (1994). The version of Treas. Reg. §1.174-2(a) applicable in Taxable Years 1 through 6 is that contained in T.D. 6255, 1957-2 C.B. 181 (hereinafter "Treas. Reg. § 1.174-2(a) (1957)"). Both versions of Treas. Reg. § 1.174-2(a) contain essentially the same language. Treas. Reg. § 1.174-2(a) (1957) defines R&E expenditures as follows:

> The term "research or experimental expenditures", as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all

> such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned.

T.D. 6255, 1957-2 C.B. 181, at 183. Accord Treas. Reg. § 1.174-2(a) (1994).[30]

Treas. Reg. § 1.174-2(a)(1) (1957) provides that R&E expenditures do not include expenditures for:

- Ordinary testing or inspection of materials or products for quality control;
- Efficiency surveys;
- Management studies;
- Consumer surveys;
- Advertising or promotions;
- Acquisition of another's patent, model, production, or process; or
- Research in connection with literary, historical, or similar projects.

T.D. 6255, 1957-2 C.B. 181, at 183. Accord Treas. Reg. § 1.174-2(a)(3) (1994).

The provisions of section 174 and Treas. Reg. § 1.174-2(a) apply not only to costs paid or incurred by a taxpayer for research and experimentation carried on directly by the taxpayer but also to costs paid or incurred for research or experimentation undertaken by a third party in behalf of the taxpayer. Expenditures for R&E undertaken by a third party in behalf of the taxpayer, however, are not section 174 expenditures to the extent that they represent expenditures for the acquisition or improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership. Treas. Reg. § 1.174-2(a)(2) (1957). Accord Treas. Reg. § 1.174-2(a)(8) (1994).

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[30] Treas. Reg. § 1.174-2(a)(1) (1994) provides the following clarification:

> Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research and experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

Under Treas. Reg. § 1.174-2(b)(1), expenditures for the acquisition or improvement of land or for the acquisition or improvement of other property which is subject to the allowances for depreciation or depletion are not eligible for the section 174 election. The allowances for depreciation or depletion, however, may be considered expenses subject to the election.

Treas. Reg. § 1.174-2(b)(2) provides that expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may be allowable as a current expense deduction, subject to the limitations of Treas. Reg. § 1.174-2(b)(4). Under Treas. Reg. § 1.174-2(b)(4), the cost of materials, labor, and other elements involved in the construction or installation of depreciable property are not R&E expenditures eligible for expensing under section 174.

In addition, Treas. Reg. § 1.174-2(b)(3) provides that if expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at its risk. No deduction is allowed if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account.

Issue 1 —
Character of cost sharing payments made pursuant to (a) the Date 1 CSA (in Taxable Years 1 and 2) and (b) the CSM (in Taxable Years 3 through 6).

Based on the Date 1 CSA and section 936, it was not appropriate for PR Co to treat the Date 1 CSA payments, or the section 936(h) CSM payments, as R&E expenditures eligible for section 174 treatment. Treas. Reg. § 1.174-2(a)(1) (1957) provides that section 174 R&E expenditures do not include the costs of acquiring another's patent, model, production, or process. Accord Treas. Reg. § 1.174-2(a)(3) (1994). Accordingly, since, as discussed below, the Date 1 CSA payments and the section 936(h) CSM payments had the character of annual consideration for the use of US Co's manufacturing intangibles in existence from time to time, such payments were ineligible for amortization pursuant to section 174(b).

The Date 1 CSA gave PR Co the right to exploit certain existing US Co affiliated group intangibles within its assigned geographic area. That right was effectively conditioned on PR Co's payment of the Date 1 CSA payments. Failure by PR Co to make such payments would have constituted a material breach triggering the termination provisions. Since it is assumed that US Co was the owner of all relevant intangibles in accordance with the provisions of the Date 1 CSA previously discussed, any default of PR Co's rights under the Date 1 CSA termination provisions would be to US Co, not PR Co. Accordingly, a termination would not involve any buy-out or other consideration to PR Co on account of any rights under the Date 1 CSA.

Thus, while labeled cost sharing payments, in our view the Date 1 CSA payments were in substance royalty consideration for the right to use US Co's manufacturing intangibles. US Co owned the manufacturing intangibles, transferred them for use to PR Co, but retained significant rights in those intangibles, such as upon a termination of the Date 1 CSA that would be triggered by a breach of PR Co of its obligation to pay the Date 1 CSA payments. US Co also retained the exclusive right to use the intangibles in the United States and many other parts of the world. Under the case law, therefore, the transaction between US Co and PR Co was a license, since the transferor, US Co, retained rights of substantial value. See, e.g., Liquid Paper Corp. v. United States, 2 Cl Ct. 284, at 289-290 (1983) (citing Hooker Chemicals & Plastics Corp. v. United States, 219 Ct. Cl. 161 (1979), Bell Intercontinental Corp. v. United States, 180 Ct. Cl. 1071 (1967), E.I. DuPont de Nemours & Co. v. United States, 153 Ct. Cl. 274 (1961), and Pickren v. United States, 378 F.2d 595 (5th Cir. 1967)).

The above analysis also applies with regard to the section 936(h) CSM payments. In addition, the statute and the White Paper confirm the analysis. The statute defines the commensurate-with-income floor on the CSM payment amount as "the inclusion or payment that would be required under section 367(d)(2)(A)(ii)[31] or section 482[32] if the electing corporation were a foreign corporation" — i.e., amounts commensurate with the income attributable to a transfer or license of existing intangible property. See I.R.C. § 936(h)(5)(C)(i)(I). This statutory language is thus evidence that Congress considered the character of section 936(h) CSM payments to be in the nature of consideration for pre-existing intangibles. The statute is also clear that the treatment of a corporation validly electing the cost sharing method as the "owner (for purposes of obtaining a return thereon)" of manufacturing intangibles is "[f]or purposes of determining the amount of its gross income derived from the active conduct of a trade or business in a possession with respect to a product produced by, or a type of service rendered by, the electing corporation for a taxable year." I.R.C. § 936(h)(5)(C)(i)(II) (emphasis added). The

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[31] Under section 367(d), certain transfers of intangible property (as defined in section 936(h)(3)(B)) by a United States person to a foreign corporation are treated as transfers in exchange for contingent payments. Accordingly, section 367(d)(2)(A)(ii) provides that the United States person shall be treated as receiving amounts which reasonably reflect the annual contingent amounts that would have been received over the useful life of the property.

[32] Section 482 provides, in relevant part: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

hypothetical treatment under the statute does not apply for other purposes, including the determination of the character of the section 936(h) CSM payments. The latter character must be determined instead under the generally applicable principles discussed above. Notably, the statutory treatment "for any taxable year" is conditioned on the payment of the section 936(h) CSM payment. See I.R.C. § 936(h)(5)(C)(i)(III)(a).

The character of the Date 1 CSA payments, and the section 936(h) CSM payments, must be determined with reference to the nature of the rights obtained by PR Co, not the measure used to calculate the amount of the payments (i.e., each party's ratable share of current year "Corporate Engineering Expense"[33] or its share of the affiliated group's "product area research" expenditures[34]). PR Co obtained solely the right to use existing intangibles of US Co. Though the costs shared related to current year activities, which would potentially create future intangibles, PR Co did not acquire any rights with respect to future intangibles it did not itself develop — and would have been able to use these intangibles, once developed, only so long as it remained a party to the arrangement and made the required payments. In light of the foregoing considerations, the White Paper clearly states that a section 936(h) cost sharing payment is compensation for previously developed intangibles. 1988-2 C.B. at 497-498 (quoted above). As noted above, section 174 R&E expenditures do not include expenditures for the acquisition of another's patent, model, production, or process. Treas. Reg. § 1.174-2(a)(1) (1957). Accord Treas. Reg. § 1.174-2(a)(3) (1994). Accordingly, a section 936(h) cost sharing payment is not a R&E expenditure as that term is defined in Treas. Reg. § 1.174-2. Instead, we consider PR Co's cost sharing payments under both the Date 1 CSA and the

[33] We additionally note that the broad definition of "Corporate Engineering Expense" ("the engineering expense of a Party and any other corporation, partnership or joint venture in which the Party owns directly or indirectly a fifty (50%) percent or greater financial interest," Date 1 CSA, pp. 4-5) would have included items that are not R&E expenditures eligible for the special treatment of section 174. It is not appropriate for expenditures otherwise ineligible for section 174 treatment to become so when shared through a cost sharing agreement.

[34] We additionally note that the definition of product area research expenditures contained in section 936(h)(5)(C)(i)(I)(a) expressly includes expenditures that are not R&E expenditures as the term is defined for purposes of section 174. See Treas. Reg. § 1.936-6(a)(1), Q&A 3. Treas. Reg. § 1.936-6(a)(1), Q&A 3 provides: "[P]roduct area research is not limited to product area research expenditures deductible under section 174 . . . . Product area research also includes deductions permitted under section 168 with respect to research property which are not deductible under section 174 . . . ."

CSM to be in the nature of royalty or license payments — i.e., annual consideration for the right to use existing US Co intangibles.[35]

For the taxable years at issue, a royalty or license payment, payable at least annually, is normally expensed in the year paid or incurred. Even if the payment is a capital expenditure for the acquisition of an intangible or intangibles (akin to purchase of a patent for a stream of royalty payments), Associated Patentees, Inc. v. Commissioner, 4 T.C. 979 (1945), acq., 1959-2 C.B. 3, and its progeny would allow an amortization deduction in an amount equal to the royalty payment. While such a payment is not technically expensed, the net effect is the same — full write-off of the royalty payment in the year paid or incurred. Thus, absent application of section 174, a royalty payment payable at least annually is, in effect, normally expensed in the year paid or incurred.

Issue 2 —
Tax consequences of ceasing to amortize payments made under the Date 1 CSA (in Taxable Years 1 and 2) and the CSM (in Taxable Years 3 through 6).

Our discussion of Issue 2 does not depend on whether PR Co was entitled to amortize its payments made to US Co under the Date 1 Cost Sharing Agreement (in Taxable Years 1 and 2) and under the CSM (in Taxable Years 3 through 6). Indeed, as discussed under Issue 1, PR Co could not properly amortize those payments. Our conclusions with respect to Issue 2 are unaffected by whether PR

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[35] If a taxpayer adopts the deferred expense method under section 174(b) but fails to deduct the amount allowed as a deduction in a given taxable year, the taxpayer may file an amended return to claim the amount allowed as a deduction, provided that the relevant taxable year is not closed by the section 6511 period of limitations. If this taxable year is closed, the deduction otherwise allowable under section 174(b) attributable to the closed year is lost and, under section 1016(a)(14) and (20), the taxpayer's basis in the unrecovered section 174(b) expenditures must be reduced by the amount of the otherwise allowable deduction. Even assuming PR Co were entitled under section 174(b) to amortize cost sharing payments, and failed to deduct the amount otherwise allowable in a given taxable year, it could file an amended return for the relevant year to claim the deduction only if this year was not closed by statute. In the present case, however, the taxable years for which PR Co failed to deduct amounts it claims are allowed as a deduction under section 174(b) — Taxable Years 7 through 10 — are all closed. Accordingly, any amounts otherwise allowable as deductions under section 174(b) for Taxable Years 7 through 10 have been lost. Given PR Co's amortization method (straight-line over 10 years), the amortization allowable in Taxable Years 7 through 10 (i.e., the lost section 174(b) amortization deduction) with respect to cost sharing payments made in Taxable Years 1 through 6 would equal 40% of these payments — and, as of the beginning of Taxable Year 11, PR Co's basis in the cost sharing payments made in Taxable Years 1 through 6 would be reduced to the extent of 40% of these payments.

Co's methods of accounting for the payments were proper under the Code or regulations.[36]

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 446(e) provides that, except as otherwise expressly provided, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his income under the new method, secure the consent of the Secretary. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder. Treas. Reg. § 1.446-1(e)(2)(i).

Section 481(a) provides that, in computing the taxpayer's taxable income for any taxable year (the "year of the change"), if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except that there shall not be taken into account any adjustment in respect of any taxable year to which section 481 does not apply unless the adjustment is attributable to a change in method of accounting initiated by the taxpayer.

Section 481(c) provides that in the case of any change described in section 481(a), the taxpayer may, in such manner and subject to such conditions as the Secretary may by regulations prescribe, take the adjustments required under section 481(a)(2) into account in computing the tax imposed for the taxable year or years permitted under such regulations.

Treas. Reg. § 1.481-1(c)(2) provides that if a change in method of accounting is voluntary (i.e., initiated by the taxpayer), the entire amount of the adjustments required by section 481(a) is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income.

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[36] In Taxable Years 1 through 6, there are only two ways these expenditures, however characterized, would be subject to amortization: (1) electing deferral and amortization under section 174(b); or (2) capitalization under section 263, followed by amortization under section 167. We are not aware of any other provision that would allow for these expenditures to be capitalized or deferred. It is important to note that the considerations discussed supra note 35 would also apply to expenditures capitalized under section 263 and amortized under section 167.

Treas. Reg. § 1.446-1(e)(3)(i) provides generally that a taxpayer seeking to secure the Commissioner's consent to the taxpayer's change in method of accounting must file an application on Form 3115 with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer agrees to the Commissioner's prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account.

Treas. Reg. § 1.446-1(e)(3)(ii) provides that the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

For most, if not all, of its existence, PR Co made annual payments to US Co with respect to manufacturing intangibles. The method for calculating the amount of the payment, the purported purpose of the payment, and the tax accounting treatment of the payment have varied over the years.

During the Date 1 CSA years (Taxable Years 1 and 2), PR Co calculated the amount of its annual payments under the terms of the Date 1 CSA. These payments entitled PR Co to the use of intangibles existing from time to time of US Co and its subsidiaries and affiliates. The Date 1 CSA year payments were amortized over 10 years.

During the CSM years (Taxable Years 3 through 6), PR Co calculated its annual payments to equal the payment required under the CSM. The payments constituted satisfaction in full of the obligations of PR Co under the amended Date 1 CSA. The CSM year payments were amortized over 10 years.

During the PSM years (Taxable Years 7 through 10), PR Co apparently continued to calculate the payments using the rules for determining the section 936(h) payment required under the CSM, rather than the rules establishing a floor on the research and development deduction under the PSM. The payments presumably constituted satisfaction in full of the obligations of PR Co under the Date 1 CSA.[37] The PSM year payments were deducted in full for each taxable year.

1. Single or multiple item(s).

An initial issue in the analysis of PR Co's tax treatment of its payments to US Co is whether, for purposes of the tax accounting method rules, the payments made to US Co in the three periods represent a single item of expense or deduction (a "tax accounting item") or multiple items of expense or deduction. This issue is complicated by the multiple ways in which these payments can be viewed and characterized:

- Under the general rules regarding deductions for trade and business expenses, including sections 162 and 174;
- Under the special rules of section 936 applicable to the calculation of the Puerto Rico and possessions tax credit;
- As a payment amount that must be calculated by some specific method; or
- As a periodic payment made under a continuing contract.

We believe the view of the payments as a periodic payment made under a continuing contract is the better view and that the payments from PR Co to US Co constitute a single item. Throughout all three periods, the payments were made pursuant to the same agreement (the Date 1 CSA), and they secured PR Co the same set of legal rights to use US Co intangibles. We also believe that a definitive resolution of the single/multiple item(s) issue is not necessary for the purposes of this advice. Treating the payments as one or multiple items will lead to differing analyses, but both of these analyses come to the same ultimate conclusions regarding how the payments should be treated with respect to the taxable years at issue.

2. Change in method of accounting.

PR Co significantly altered its tax treatment of its payments to US Co in Taxable Year 7. During the Date 1 CSA years (Taxable Years 1 and 2) and CSM years (Taxable Years 3 through 6), PR Co amortized its payments to US Co over a 10 year period. During the PSM years (Taxable Years 7 through 10), PR Co deducted

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[37] We are not aware of any amendment to the Date 1 CSA providing that a payment equal to the research and development deduction under the PSM would constitute full satisfaction of PR Co's obligations under the Date 1 CSA. This is arguably not consequential in light of two considerations. First, if the Date 1 CSA continued in force, the PSM year payments were apparently accepted by the parties as full satisfaction of PR Co's obligations. Second, the payments during the PSM years were generally equal to the section 936(h) payments that would have been made under the CSM, which was covered by the amendment to the Date 1 CSA discussed above.

its payments to US Co in full in each taxable year and suspended its amortization with respect to payments made during the Date 1 CSA years and CSM years.

We believe that the alterations made in Taxable Year 7 constitute an unauthorized change in method of accounting. This is true without regard to whether the payments during the PSM years are considered to be the same accounting item as the payments made in the Date 1 CSA and CSM years, although the analysis of the change differs somewhat under these two different alternatives.

If all of PR Co's payments to US Co constitute a <u>single tax accounting item</u>, then PR Co changes its method of accounting for that item in Taxable Year 7, when PR Co abandons its prior practice of amortizing the item over 10 years and begins deducting the item in full in the year incurred. This is a change in the proper time for taking a deduction, and constitutes a change in method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(a). PR Co does not obtain the consent of the Commissioner to make such a change as required under section 446(e), and does not take into account any adjustment to prevent the omission or duplication of amounts as required under section 481(a).

If PR Co's payments to US Co during the PSM years constitute a <u>different tax accounting item</u> from the payments in the Date 1 CSA and CSM years, then a different analysis follows. The payments made to US Co during the PSM years constitute a new tax accounting item, and PR Co adopts a method of accounting (deduction in full) with respect to this new item in Taxable Year 7. The unamortized portion of the payments made to US Co during the Date 1 CSA and CSM years constitutes an existing tax accounting item, and PR Co must continue to amortize these amounts under the existing 10 year amortization method established for this item until it obtains the consent of the Commissioner to change this method. PR Co does not obtain such consent, but nevertheless suspends amortization of these amounts in Taxable Year 7. Such suspension can be interpreted in two different ways.

First, the suspension of the amortization in Taxable Year 7 can be viewed as PR Co making an unauthorized change in method of accounting, in which PR Co substitutes a new method of accounting — deduction in full in the year incurred — for its existing 10 year amortization method. PR Co does not obtain the consent of the Commissioner to make such a change as required under section 446(e), and does not take into account any adjustment to prevent the omission or duplication of amounts as required under section 481(a).

Second, the suspension can be construed as PR Co simply failing to follow its ongoing and unchanged method of 10 year amortization. The taxpayer may attempt to support this construction by arguing that it could not have made a method change because it did not request permission to do so. In essence, this argument implies that a hypothetical incident of inaction — the failure to seek the consent of the Commissioner — is better evidence of PR Co's accounting methodology than PR Co's consistent pattern of tax accounting over multiple tax years. We find this argument unconvincing. PR Co's failure to seek required consent to change a method of accounting is at best weak evidence that PR Co did not change its method of accounting, and cannot in any event prevail over evidence of PR Co's actions to the contrary.

Moreover, even if the suspension of amortization did not constitute a change in method of accounting, PR Co would have failed to take its amortization deductions into account during the proper taxable years under its established method of accounting, and would now be barred by the statute of limitations from taking these amounts into account to reduce tax liability in open taxable years. Treas. Reg. § 1.461-1(a)(3).

Of these two alternative constructions of the suspension of amortization, we believe the better interpretation is that PR Co's suspension of amortization in Taxable Year 7 was an unauthorized change in method of accounting for the pre-Taxable Year 7 payments from its existing 10 year amortization method to a method of deducting the payments in full in the year incurred. This conclusion is supported by two considerations. First, PR Co adopted the same method for the payments made during the PSM years. Second, PR Co failed to amortize the pre-Taxable Year 7 payments throughout the four consecutive PSM years, which demonstrates the consistency of application that is characteristic of a method of accounting rather than an error.

In sum, we believe, as stated above, that the payments made by PR Co to US Co during the Date 1 CSA years, the CSM years, and the PSM years constitute a single tax accounting item, and that PR Co changed its method of accounting for that item in Taxable Year 7. If, however, PR Co's payments during the PSM years do constitute a different tax accounting item from the payments during the Date 1 CSA years and the CSM years, then we believe that PR Co changed its method of accounting for the payments made during the Date 1 CSA and CSM years in Taxable Year 7. In either case, the change in method of accounting was made without obtaining the required consent of the Commissioner under section 446(e) or taking into account the negative adjustment under section 481(a).

3. Consent of the Commissioner and the section 481(a) adjustment.

PR Co was required to secure the consent of the Commissioner before it computed its taxable income under a new method of accounting for Taxable Year 7. I.R.C. § 446(e). Such consent was required without regard to whether the new method of accounting was proper or permitted under the Code or the regulations thereunder. Treas. Reg. § 1.446-1(e)(2)(i). Such consent was also required without regard to whether the prior method of accounting was proper or permissible. Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3d Cir.), cert. denied, 368 U.S. 898 (1961). PR Co failed to secure the required consent, and thus made an unauthorized change in method of accounting.

When PR Co made its unauthorized change in method of accounting in Taxable Year 7, it was required to take into account any adjustment necessary to prevent amounts from being duplicated or omitted as a result of the change (the "section 481(a) adjustment"). I.R.C. § 481(a); Treas. Reg. § 1.481-1(a)(1). As explained below, the amount of the section 481(a) adjustment that PR Co was required to make is the same regardless of whether the payments made during the PSM years are considered to be the same accounting item as the payments made in the Date 1 CSA and CSM years.

If all of PR Co's payments to US Co constitute a single tax accounting item, then a negative section 481(a) adjustment would be necessary to prevent omission of the unamortized portion of the payments made during the Date 1 CSA and CSM years. These unamortized payments would never be deductible under PR Co's new method of deducting the payments in full in the year incurred, and thus would be omitted because of the change in method if the section 481(a) adjustment were not made.

If PR Co's payments to US Co during the PSM years constitute a different tax accounting item from the payments in the Date 1 CSA and CSM years, then a negative section 481(a) adjustment would also be necessary to prevent omission of the unamortized portion of the payments made during the Date 1 CSA and CSM years. Under PR Co's new method of accounting for such payments, which apparently is deduction in full in the year incurred, these unamortized payments would never be deductible, and thus would be omitted because of the change in method if the section 481(a) adjustment were not made.

PR Co was required to take its section 481(a) adjustment into account in full in Taxable Year 7, the year in which the change in method of accounting occurred (the "year of change"). The entire amount of any section 481(a) adjustment must be taken into account in the year of change, unless the Commissioner grants consent to take such adjustment into account in other years. I.R.C. § 481(a); Treas. Reg. §§ 1.481-1(a)(1), 1.481-1(c)(2), 1.481-1(c)(3). PR Co did not obtain the consent of the Commissioner to take its section 481(a) adjustment into account in any year other than the year of change.

PR Co failed to take its section 481(a) adjustment into account in Taxable Year 7, the year of its unauthorized change in method of accounting. Taxable Year 7 is now closed by statute, precluding PR Co from including the section 481(a) adjustment by amending its return.

PR Co cannot take deductions in the taxable years at issue (Taxable Years 13 through 15) for amortization of the payments made during the Date 1 CSA and CSM years. In Taxable Year 7, PR Co changed its method of accounting for cost sharing payments to deduction of the payment in the year incurred. These payments were not incurred in the tax years at issue and thus cannot be deducted in such years.

Similarly, PR Co cannot take any portion of its missed section 481(a) adjustment into account in the taxable years at issue. PR Co failed to obtain the consent of the Commissioner to take its section 481(a) adjustment in any taxable year subsequent to the year of change (Taxable Year 7). Accordingly, PR Co lost the section 481(a) adjustment by failing to take it into account in the year of the change as required by section 481 and the regulations thereunder.

Viewed another way, the amounts which PR Co deducted in the taxable years at issue with respect to the payments to US Co in the Date 1 CSA and CSM years are all omitted deductions under its new method of accounting. These amounts should have been taken into account as part of a section 481(a) adjustment in Taxable Year 7, the tax year in which PR Co made its unauthorized change in method of accounting. PR Co lost that section 481(a) adjustment by failing to take it into account in the year of the change as required by statute. PR Co cannot secure the benefit of that adjustment in subsequent years. Cf. Hackensack Water Co. v. United States, 352 F.2d 807 (Ct. Cl. 1965) (taxpayer who failed to request permission for a change in method of accounting in 1953 not entitled to refund, claimed in 1955, which essentially sought the benefit of the negative adjustment it should have taken into account in the year of the change); Bullard Co. v. United States, 364 F.2d 429 (Ct. Cl. 1966) (following Hackensack Water Co. under similar facts).

4. Issue 2 Conclusion

In the taxable years at issue, PR Co may not claim any deductions attributable to cost sharing payments made to US Co during the Date 1 CSA years (Taxable Years 1 and 2) or the CSM years (Taxable Years 3 through 6). The unamortized portion of these payments should have been taken as a negative section 481(a) adjustment in Taxable Year 7, the year in which PR Co made an unauthorized change in method of accounting. PR Co failed to take the section 481(a) adjustment in Taxable Year 7 and thus lost the ability to deduct these amount in any form in subsequent taxable years.

These conclusions remain true without regard to whether the payments from PR Co to US Co over the years constitute the same item or multiple items for purpose of the tax accounting method rules. These conclusions are also unaffected by whether PR Co's methods of accounting for these payments were proper under the Code or regulations.

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We emphasize that our technical analysis also effects a result consistent with policy considerations and avoiding an abusive result. The taxpayer's position would involve deferring the periods in which substantial unamortized amounts of the payments would be taken into account. Instead of taking those payment amounts into account when incurred in periods during which PR Co was effectively tax-exempt, they would be postponed to be taken into account when they would reduce taxable income of the US Co group. In our view, this would result in an abuse. During the period in which cost sharing payments were amortized rather than currently deducted, the income of the section 936 corporation was effectively exempt from United States tax and, therefore, amortization of the cost sharing payments produced the same tax consequences as would a current deduction. By amortizing and later deducting the unamortized amount at a time when the section 936 corporation had revoked its election and joined the consolidated group (and, later, when the former 936 corporation was liquidated into its parent), the taxpayer would be able to deduct amounts that never had any tax effect.

Please call (202) 874-1490 if you have any further questions.

By: JACOB FELDMAN
Special Counsel
Office of Associate Chief Counsel
(International)