INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 4, 2001

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CASE MIS No.: TAM-130855-01/CC:CORP:B1

Attention:

Taxpayer's Name:
Taxpayer's Address:

Taxpayer Identification Number:
Years Involved:
Date of Conference:

LEGEND:

X =

Y = .

Z =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Change Date =

a =

b =

c =

d =

e =

f =

g =

ISSUE:

Whether any portion of the income earned from X's existing patient base as of the ownership change date should be treated as recognized built-in gain ("RBIG") for purposes of § 382(h)(6) of the Internal Revenue Code.

CONCLUSION:

No portion of the income earned from X's existing patient base as of the ownership change date should be treated as RBIG for purposes of § 382(h)(6).

FACTS:

Background:

Our understanding of the facts is as follows:

X, the common parent of an affiliated group filing a consolidated return, underwent an ownership change on the Change Date as a result of X's initial public offering. On the change date, X's stock had a fair market value of approximately $a. X was subject to a § 382 limitation of approximately $b and possessed net operating loss carryforwards ("NOLs") of $c. X provided products and services. As of the change date, X held an "existing patient base" (*i.e.*, patients for whom X supplied products and services as of the change date) with a book and tax basis of zero. X generated income in the years after the Change Date ("postchange period"), including Years 1, 2, and 3, by providing and related services to the existing patient base. For Years 1, 2, and 3 the X consolidated group earned taxable income that could not be offset by its NOLs due to the § 382 limitation.

In , Y merged into X. The surviving entity changed its name to Z, and continued the same line of business. Prior to expiration of the statutory limitations period, Z requested refunds for the X consolidated group's tax years Years 1, 2, and 3. Z claims that, for these years, X's § 382 limitation should be increased "due to built-in gain recognition pursuant to IRC Section 382(h)." Z's claims are based on its position that § 382(h)(6) should be construed to apply to income generated from the existing patient base held by X at the time of the ownership change.

Z valued X’s existing patient base by determining the anticipated postchange profit stream from the existing patient base and discounting the amount to present value on the Change Date. Based on this methodology, Z determined that the built-in gain of the existing patient base was $d. Z computed the income from the patient base during the recognition period taxable years by subtracting operating expenses from gross receipts in those years. Z attributed the recognition period income to the prechange period. Z determined that the existing patient base generated approximately $e, $f, and $g, in Years 1, 2, and 3, respectively. Z treated those entire amounts as attributable to built-in gain of the patient base. Z did not treat any part of those amounts as attributable to postchange services Z provided. Z states that its approach treated postchange income as attributable to the prechange period only to the extent that it corresponded to the existing patient base’s estimated decline in value (“wasting”).

Agent’s Position

The Internal Revenue Agent takes the position that no portion of the income earned from a wasting asset, such as X’s existing patient base, should be treated as recognized built-in gain for purposes of § 382(h)(6). In addition, the Agent determined that the taxpayer’s postchange services regarding the patient base were necessary to generate the postchange income in question, and that the income thus was not attributable to the prechange period under § 382(h)(6).

Taxpayer’s Position

Taxpayer contends that because prechange activities and expenses created the patient base, and the patient base produced postchange income, that income is attributable to the prechange period. Taxpayer argues that income from the existing patient base is economically equivalent to income realized on an asset’s disposition, because both types of income reflect a realization of value inherent on the Change Date.

DISCUSSION

Section 382 provides that, after an ownership change, the amount of a loss corporation’s taxable income for any postchange year available for offset by prechange NOLs shall not exceed the § 382 limitation for that year. Section 382(a). The § 382 limitation equals the fair market value (“FMV”) of the corporation’s stock as of the change date multiplied by the long term tax-exempt rate. The § 382 limitation represents the hypothetical return on a loss corporation’s value had it not undergone an ownership change. By limiting the absorption of NOLs to the hypothetical return of a loss corporation, Congress attempted to eliminate tax bias for or against the sale of loss corporations based on their NOLs. The neutrality paradigm of § 382 restrains a loss corporation from using losses beyond those it would have been able to use in the absence of an ownership change. S. Rep. No. 99-313, at 231 (1986).

If a corporation has a net unrealized built-in gain ("NUBIG"), its recognized built-in gain ("RBIG") increases the § 382 limitation for any taxable year within the 5-year recognition period following the ownership change. Section 382(h)(1)(A). A corporation's NUBIG equals the fair market value ("FMV") of its assets over the basis of its assets on the change date. Section 382(h)(3)(A). A corporation has RBIG on the disposition of any asset to the extent the asset's FMV exceeded its basis immediately before the change date. Section 382(h)(2)(A).

If a corporation has a net unrealized built-in loss ("NUBIL"), its recognized built-in loss ("RBIL") is subject to the § 382 limitation for any taxable year within the 5-year recognition period following the ownership change. Section 382(h)(1)(B). A corporation's NUBIL equals the basis of its assets over the FMV of its assets on the change date. Section 382(h)(3)(A). A corporation has RBIL on the disposition of any asset to the extent the asset's basis exceeded its FMV immediately before the change date. Section 382(h)(2)(B).

Section 382(h)(6) provides that items of income or deduction taken into account after the change date but attributable to the prechange period are treated as RBIG or RBIL. As enacted in 1986, § 382(h)(6) provided that "[t]he Secretary may by regulation treat amounts which accrue on or before the change date but which are allowable as a deduction after such date as recognized built-in losses."

In the Conference Report to TRA 86, Congress indicated that deductions of deferred items under §§ 267 and 465, but not depreciation deductions, were appropriate to be treated as RBIL under § 382(h)(6). Specifically, the Conference Report states that:

> The Treasury Department is authorized to issue regulations under which amounts that accrue before the change date, but are allowable as a deduction on or after such date (*e.g.*, deductions deferred by § 267 or § 465), will be treated as built-in losses. Under the conference agreement, depreciation deductions cannot be treated as accrued deductions or built-in losses. The conference agreement, however, requires the Secretary of the Treasury to conduct a study of whether built-in depreciation deductions should be subject to section 382, and report to the tax-writing committees of the Congress before January 1, 1989.

H.R. Rep. No. 99-841, at 191 (1986).

The General Explanation of the Tax Reform Act of 1986, Staff of Joint Committee on Taxation, 100th Cong., 1st Sess. (May 4, 1987), at pp. 320-321, states:

> Depreciation deductions cannot be treated as deductions or built-in losses; [36] however, the Secretary of the Treasury is required to conduct a

study of whether built-in depreciation deductions should be subject to section 382…

[36] Similarly, Section 382 does not provide relief for built-in income other than gain on disposition of an asset.

Section 10225(b) of The Omnibus Budget Reconciliation Act of 1987, (P.L. 100-203), ("OBRA 87"), amended § 382(h)(2)(B) to provide that the term "recognized built-in loss" includes "any amount allowable as depreciation, amortization, or depletion for any period within the recognition period" except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset's adjusted basis over its fair market value on the change date. The Conference Report clarified this change as follows:

> The conference agreement follows the House bill with respect to built-in depreciation being subject to the built-in loss rules of section 382 . . . . The preacquisition losses that may not be used to shelter built-in gains include built-in losses or items of deduction that have economically accrued prior to deduction.

H.R. Rep. No.100-495, at 973 (1987).

In § 1006(d)(22) of the Technical and Miscellaneous Revenue Act of 1988, (P.L. 100-647) ("TAMRA 88"), Congress amended § 382(h)(6) to provide that any item of income or deduction that is properly taken into account during the recognition period but "which is attributable to periods before the change date" is treated as RBIG or RBIL for the taxable year in which the item is taken into account. This amendment was effective as though it were included in TRA 86 (See § 1019 of TAMRA 88). Section 382(h)(6)(C) provides that "the amount of the net unrealized built-in gain or loss shall be properly adjusted for amounts which would be treated as recognized built-in gains or losses under this paragraph if such amounts were properly taken into account (or allowable as a deduction) during the recognition period."

The Senate Report addressing the amendments to § 382(h)(6) added by TAMRA 88 explained:

> The amendment clarifies that any item of income which is properly taken into account during the recognition period but that is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account. Such items would include accounts receivable of a cash method taxpayer that arose before the change date and are collected after that date, the gain on completion of a long term contract performed by a taxpayer using the completed contract method of accounting that is attributable to periods before the change date, and the recognition of income attributable to periods before the change date pursuant to section 481

> adjustments, for example, where the loss corporation was required to change to the accrual method of accounting pursuant to Code section 448.
>
> Also, any amount which is allowable as a deduction during the recognition period but which is attributable to periods before the change date shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction. The committee intends that this provision shall be effective with respect to amounts allowable as depreciation, amortization, or depletion only to the extent consistent with the special effective date provided in the Revenue Act of 1987 for such items.

S. Rep. No. 100-445, at 65 (1988). The TAMRA 88 legislative history does not explain the significance of the change in terms from "accrue," used in TRA 86, to "attributable to," used in TAMRA 88.

The language of footnote 36 in the Joint Committee's explanation suggests that in 1986 Congress did not intend income from an asset's consumption to be treated as akin to gain from a disposition. The juxtaposition of the footnote with the statement of Congressional position regarding depreciation deductions arguably suggests that income and deductions from wasting assets should be treated similarly. Congress explicitly reversed its position in OBRA 87 and TAMRA 88 on the treatment of depreciation as RBIL. OBRA 87 provided that depreciation, amortization, and depletion deductions would be treated as RBIL under § 382(h)(2)(B) to the extent attributable to an asset's BIL, and the legislative history to TAMRA 88 clarified that these deductions would be treated as RBIL under § 382(h)(6). TAMRA 88 also added § 382(h)(6)(A), which treats as RBIG items of income properly taken into account in the postchange period but that are attributable to the prechange period. Because the Congressional explanation of TRA 86 indicates that income and deduction items from an asset's consumption are treated "similarly," Z contends that it is reasonable to infer that by 1988 Congress intended income from wasting assets that is attributable to the prechange period to be treated as RBIG.

Z contends that further support for this position is found in a 1993 Field Service Advice, TL-N-5525-93 (July 8, 1993):

> Under I.R.C. section 382(h)(2), postchange depreciation that is attributable to prechange built-in loss is treated as recognized built-in loss. The flip side to this situation is that postchange income attributable to prechange depreciation, which generated the built-in gain, should be treated as recognized built-in gain . . . . Based on the above, it could be argued that Congress wanted to include, in the list of recognized built-in gain items, income generated from expensed assets containing built-in gain.

The Agent distinguishes the FSA by emphasizing that in the FSA, the software that generated the licensing income "was fully expensed prior to the change date" and there was “an undeniable close relationship between the software development costs that created the NOLs and the licensing income flowing from that software” while X’s postchange activities (*i.e.*, services provided for which expenses were incurred in the postchange period) rather than prechange activities essentially generated the revenue received during the recognition period taxable years Years 1, 2, and 3.

Z also contends that in each of the examples included in the House and Senate reports (“committee examples”), the items of income or deduction attributable to economic activity and events occurring before the change date were treated as a recognized built-in gain or loss after the change date. Z argues that this treatment is similar to the economic accrual concept used to determine what part of the gain or loss on a disposition of an asset during the recognition period is RBIG under § 382(h)(2), and that a logical extension of the economic accrual model would treat income taken into account during the recognition period as RBIG to the extent it is economically attributable to periods before the change date under § 382(h)(6).

We believe it significant that Congress did not provide flush language in § 382(h)(2)(A) to mirror that in § 382(h)(2)(B). In 1986, § 382(h)(6) did not provide for the treatment of any postchange income as RBIG; the legislative history footnote served as a blanket statement disallowing the treatment of income items as RBIG. The 1988 negation of the footnote through the adoption of § 382(h)(6)(A) does not necessarily endorse the treatment of income from wasting assets as RBIG. Rather, the legislative change merely allows the treatment of certain income items as RBIG. Congress failed to discuss its reasons for omitting similar flush language from § 382(h)(2)(A), but this omission implies that RBIG does not include income from wasting assets. The only legislative history arguably supporting the inclusion of wasting assets income relies on the connection to the flush language of § 382(h)(2)(B) treating depreciation, amortization, and depletion deductions as RBIL. We believe this connection is a tenuous one.

The legislative history provides examples of postchange income that is attributable to the prechange period, and thus treated as RBIG, but these examples are distinguishable from income from wasting assets. Although Congress did not delineate by statute the types of income subject to § 382(h)(6), the committee examples indicate that § 382(h)(6) applies to items of income that have “accrued” (*i.e.*, fixed the right to income) in some sense, but because of the taxpayer’s accounting method or a statutory deferral provision the income was taken into account in a later period. The examples in the § 382(h)(6) legislative history fall into several categories, including: (1) items that are recognized but deferred (such as deductions under §§ 267 and 465); (2) items that are realized but not recognized (e.g., the accounts receivable of a cash method taxpayer); and (3) other items attributable to the prechange period, but taken into account in the postchange period (such as § 481 adjustments). A wasting asset with built-in gain, however, merely has a FMV that exceeds its basis in the prechange period; it has not in any sense fixed a right to income that will be taken into account in the postchange period.

There also exist significant administrability concerns about treating income from wasting assets as RBIG. With respect to depreciation, amortization and depletion deductions, the amount of the deduction treated as RBIL can be determined based on the asset's statutory estimated useful life. If the costs of a BIG asset have been expensed, however, and the asset therefore is not subject to tax depreciation, amortization or depletion, there is no fixed schedule on which to base economic depreciation assumptions. In the absence of an identified useful life over which to assume a fixed rate of depreciation, the Service and taxpayers would have to develop an alternative methodology for determining the rate of BIG consumption. Devising such a methodology likely would involve sophisticated economic and statistical calculations.

Because Congress nowhere indicated with any specificity that the treatment of income from wasting assets should mirror the treatment of the deductions enumerated in the flush language of § 382(h)(2)(B), we conclude that income from wasting assets should not be treated as RBIG. Administrability issues and the ambiguity of the legislative history vitiate the argument that treating income from wasting assets as RBIG is merely the "flip side" of treating depreciation, amortization, and depletion deductions as RBIL.

CAVEAT(S)

Temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not yet been adopted. This memorandum therefore will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the memorandum. See section 17.04 of Rev. Proc. 98-2, 1998-1 I.R.B. 74, 95 (or any successor). A technical advice memorandum that modifies or revokes a letter ruling or another technical advice memorandum generally is not applied retroactively if the taxpayer can demonstrate that the criteria in section 17.06 of Rev. Proc. 98-2, are satisfied.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.