Losses Claimed on Certain Intangible Assets

Notice 2000–34

This notice informs Blue Cross Blue Shield insurance organizations ("BCBS organizations") that the Internal Revenue Service will challenge deductions for losses for the termination of individual customer, provider, or employee contracts or relationships associated with customer lists, provider networks, and workforce in place with respect to which the taxpayer claims an adjusted basis derived from § 1012(c)(3)(A)(ii) of the Tax Reform Act of 1986 (the Act).

Section 1012 of the Act revoked the tax-exempt status of BCBS organizations and added § 833 of the Internal Revenue Code (the "Code"), which treats those organizations as taxable stock insurance companies. Under § 1012(c)(3)(A)(ii) of the Act, each organization's adjusted bases in its assets, for purposes of determining gain or loss, is deemed equal to the assets' fair market values as of the first day of its first taxable year beginning after December 31, 1986.

The Conference Committee Report accompanying the Act states that this fair market value basis adjustment was provided "solely for purposes of determining gain or loss upon the sale or exchange of the assets, not for purposes of determining amounts of depreciation or for other purposes." H.R. Conf. Rept. 841, 99th Cong., 2d Sess. II- 350 (1986). The Conference Report further clarifies that the basis adjustment was provided because

the conferees believed that the formerly tax-exempt organizations should not be taxed on unrealized appreciation or depreciation that accrued during the period the organization was not generally subject to income taxation. *Id*.

The Service has learned that some BCBS organizations are claiming annual or periodic loss deductions under § 165 of the Code with respect to certain intangible assets, including customer lists, provider networks, and workforce in place using the fair market value basis provided under § 1012(c)(3)(A)(ii) of the Act for purposes of determining gain or loss. For example, some BCBS organizations are claiming loss deductions in the year in which a customer terminates its relationship with the BCBS plan, on the theory that each customer relationship is a separate asset for federal income tax purposes.

The Service believes that BCBS organizations are not entitled to these loss deductions. In addition to carefully scrutinizing the valuations obtained for the assets at issue, the Service will challenge the loss deductions under various theories, as appropriate, including the following:

- These individual customer, provider, or employee contracts or relationships are not separate assets. The Supreme Court's decision in *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993), did not disturb earlier authority denying current loss deductions upon the termination of an individual customer, provider, or employee contract or relationship or similar component of a single asset. *See, e.g.*, *Golden State Towel and Linen Service v. United States*, 373 F.2d 938 (Ct. Cl. 1967). In *Newark Morning Ledger*, the Supreme Court cited *Golden State Towel* with approval.
- Under the facts set forth above, annual or periodic loss deductions are the functional equivalent of amortizing the single assets composed of individual customer, provider, or employee contracts or relationships, and as such are contrary to Congress's express prohibition against using the § 1012(c)(3)(A)(ii) basis for amortization purposes. That is, some BCBS organizations are using these annual loss deductions as a mechanism for regularly converting a portion of a single intangible asset's § 1012(c)(3)(A)(ii) basis into an offset against current income, producing the same tax effect as amortizing that asset's § 1012(c)(3)(A)(ii) basis.
- By enacting § 1012 of the Act, Congress intended to take away the advantage the BCBS organizations enjoyed as tax-exempt entities in competing with commercial insurance companies by subjecting the BCBS organizations to the payment of federal income taxes to the same extent as commercial insurance providers. H.R. Rep. No. 426, 99th Cong., 1st Sess. 664 (1985). The legislative history to the Act indicates that Congress expected to remedy this inequity immediately, with the BCBS organizations beginning to pay tax in their initial years as taxable entities. The annual use of a portion of the § 1012(c)(3)(A)(ii) basis to offset a substantial amount of taxable income immediately upon becoming taxable would permit BCBS organizations to maintain the competitive advantage they enjoyed prior to the Act by effectively delaying for many years their obligation to pay federal income taxes to the same extent as other commercial insurance providers.
- By not having claimed loss deductions upon the termination of individual customer, provider, or employee contracts or relationships in prior years, BCBS organizations effectively adopted a method of accounting that treats customer lists, provider networks, and workforce in place as single assets composed of individual customer, provider, or employee contracts or relationships. A method of accounting cannot be changed without permission from the Secretary. Section 446(e); Rev. Rul. 90–38, 1990–1 C.B. 57. BCBS insurance organizations that file claims for refund to begin recovering the basis in individual customer, provider, or employee contracts or relationships that terminated in prior years are attempting to make an unauthorized change in method of accounting. *See* Treas. Reg. § 1.446–1(e)(2)(ii)(a).

DRAFTING INFORMATION

The principal author of this notice is Grace Matuszeski of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice contact Kay Hossofsky of the Office of the Associate Chief Counsel (Financial Institutions & Products) at (202) 622-3970 (not a toll-