DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

CC:DOM:FS:[redacted]

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Assistant Regional Counsel (LC) CC:SER

FROM: Assistant Chief Counsel (Field Service)

SUBJECT:

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

LEGEND:

S	=
T	=
U	=
V	=
W	=
WW	=
X	=
XX	=
Y	=
Z	=
State 1:	=
State 2:	=
Date 1:	=
Date 2:	=
Date 3:	=
Date 4:	=
Date 5:	=
Date 6:	=
Date 7:	=

[redacted]

Date 8:	=
Date 9:	=
Date 10:	=
Date 11:	=
Year 1:	=
Year 2:	=
Year 3:	=
Year 4:	=
$x1:	=
$x2:	=
$x3:	=
$x4:	=
$x5:	=
$x6:	=
$x7:	=
$x8:	=
$x9:	=

ISSUES:

1. Whether the "payment option" granted in the asset purchase agreement between S and T should be treated as a valid option.

2. Whether S's change in treatment of the $x1 payment in Date 1 from treatment as capitalized expense and amortized over 15 years pursuant to section 197 to treatment as a section 1234 deduction in the year incurred, is a change in method of accounting for which the permission of the Commissioner is required.

CONCLUSIONS:

1. Given the facts that we have received, we conclude that the agreement creates valid options. However, further factual development in this regard will be necessary. If further factual development supports our conclusion with respect to Issue 1, S should have originally treated the $x1 payment to terminate the "payment option" as an ordinary income deduction pursuant to Treas. Reg. § 1.1234-1(b).

2. The change from classification of $x1 payment in Date 1 from intangible goodwill to repurchase of an option involves an issue of timing and thus involves a change in method of accounting. Although S is changing from an impermissible to a

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permissible method of accounting, such change still requires the Commissioner's consent.

FACTS:

In early Year 1, T, which operated a in State 1, concluded that its current facilities could no longer satisfy the needs of . T's board determined that a new facility was necessary. Accordingly, the board began to explore the possibility of selling its current facilities. Ultimately, on Date 2, T and S entered into an asset purchase agreement. Pursuant to the agreement, T agreed to sell to S all of the assets of the contingent on S agreeing to construct and maintain a replacement facility. S leased the old facility from T and assumed responsibility for its operations. The parties closed the sales transaction on Date 3. S paid T $x2 at closing, which, after certain adjustments, resulted in T receiving $x3. With respect to the old , S agreed to pay rent, real estate taxes, insurance premiums, utilities, cost of repairs and maintenance.

The agreement contained additional covenants and provisions. For example, S agreed to (1) retain all current employees and staff; (2) ; (3) limit ; (4) provide for on the board; (5) provide services; (6) grant T design approval of the new ; (7) expend at least $x4 for the construction of the new ; and, (8) allow T to designate eight of the nine members of the board.

On Date 4, S received a for the construction of the new facility. S purchased real property and began construction of a replacement . The new opened on Date 5.

Pursuant to the asset purchase agreement, T held options to repurchase the new facility from S. Specifically, the agreement granted T the option to acquire the assets of the new beginning five years after the new commenced operations at a price representing the depreciated book value. It is significant to note that if T subsequently transferred the assets within five years of exercising the option, T was obligated to pay to S any profit received upon the subsequent disposition of the assets. Section of the Asset Purchase Agreement. The agreement granted T a second option to purchase the assets of the new beginning 10 years after the new commenced operations at a price representing the fair market value of the assets. Section of the Asset Purchase Agreement.

[redacted]

By letter dated Date 6, T notified S of its intention to exercise its first option to purchase the assets of the replacement . On Date 7, the parties, however, entered into a Modification Agreement pursuant to which S agreed to pay T $x1 to terminate T's options.

S originally reported the $x1 payment on its Year 2 tax return as a purchase of goodwill and amortized this amount over 15 years pursuant to section 197. S, however, subsequently filed an informal claim with respect to its Year 2 tax year asserting that the payment was made to terminate an option, and thus is deductible as an ordinary expense pursuant to Treas. Reg. § 1.1234-1(b).

Issue 1

LAW:

You have requested our assistance regarding whether T held valid options to acquire the assets of the new . To answer this question, we must first determine when the original sale occurred. If the sale occurred in Year 3, then sections of the Asset Purchase Agreement dated Date 2, arguably provide T with call options to purchase the assets of the new . If the sale of assets did not occur until , then the $x1 payment could potentially be viewed as a payment by S to acquire a residual interest. The issue turns on when the benefits and burdens of ownership passed from T to S.

Some of the benefits and burdens that courts consider include: (1) whether and when legal title was transferred; (2) how the parties treated the transaction; (3) whether the purported purchaser acquired any equity in the property; (4) whether the contract created a present obligation on the purchaser to make payments; (5) whether and when the right of possession was vested in the purchaser; (6) which party bore the risk of loss or damage to the property; and (7) which party received the opportunity for gain. See Grodt & McKay, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981); Cherin v. Commissioner, 89 T.C. 986, 997 (1987); and Amdahl Corporation v. Commissioner, 108 T.C. 507, 517-18 (1997).

ANALYSIS:

Based on the facts that we have received, we conclude that several of the benefits and burdens of ownership appear to have shifted to S in Year 3. For example, a review of the asset purchase agreement indicates that the risk of loss and opportunity for gain shifted to S in Year 3. S purchased the assets of the old and assumed responsibility for operating and maintaining both the old and new . If the assets decreased in value or the proved to be

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unprofitable, S bore the risk of loss. There is nothing in the purchase agreement or other documents that we received that would indicate that T guaranteed S a specific return on its investment or a contribution of money in the event of revenue shortfalls. Moreover, if the assets depreciated in value, T was not obligated to purchase the assets from S. T retained the right but not the obligation to purchase the assets of the new .

In addition, as between T and S, S received the opportunity for gain. T could exercise its option to purchase the assets of the new at depreciated book value beginning five years after the commenced operations. However, if within five years of exercising its option, T subsequently transferred the new assets at a profit, T was obligated to surrender the profits to S. Asset Purchase Agreement Section . If T chose to exercise the second option, the option described in Section of the agreement, T was obligated to pay S fair market value for the assets.

Another criterion is whether the contract created a present obligation on the purchaser to make payments. Here, the asset agreement imposed present obligations on S to make payments. For example, the asset purchase agreement imposed on S the obligation to pay T $x2 at closing. In addition, S was obligated under the agreement to spend at least $x4 construct a new . S was also obligated to pay the costs associated with operating and maintaining both the old and the new .

The next criterion is whether and when the right of possession was vested in the purchaser. Pursuant to the sales transaction, S entered into an agreement on Date 3 to manage the old . Although it is unclear from the facts that we have been provided, it appears that S took immediate possession of the old and operated it consistent with the terms of the various agreements.

If further factual development shows that the benefits and burdens of ownership of the facilities and assets shifted to S in Year 3, we would conclude that the asset purchase agreement gave rise to a sale in Year 3 with options to purchase the assets of the new in subsequent years. We would further conclude that the $x1 payment that S paid to T in Year 2 was paid to terminate the options. As a result, S should have originally treated the $x1 payment as an ordinary deduction pursuant to Treas. Reg. § 1.1234-1(b).

Issue 2

LAW:

A change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan is a change in method of accounting. A material item is any item which involves the proper time

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for the inclusion of the item in income or the taking of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a). A method of accounting for a particular item which is properly treated is established once it is on one tax return. Treas. Reg. § 1.446-1(e)(2)(ii)(a); Rev. Rul. 90-38, 1990-1 C.B. 57. In contrast, an item must be treated incorrectly for a minimum of two years before a method of accounting is established. Treas. Reg. § 1.446-1(e)(2)(ii)(a); Rev. Rul. 90-38, 1990-1 C.B. 57; Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989). Thus, consistent, but erroneous, treatment of a material item constitutes a method of accounting. Treas. Reg. § 1.446-1(e)(2)(iii), Examples (6) - (8). See also Commissioner v. O Liquidating Corp., 292 F.2d 225 (3d Cir. 1961), cert. denied, 368 U.S. 898 (1961); Fruehauf Trailer Corp. v. Commissioner, 356 F.2d 975 (6th Cir. 1966), cert. denied, 385 U.S. 822 (1966).

The correction of a mathematical or posting error, or errors in the computations of tax liability does not constitute a method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(b). Likewise, changes that affect lifetime income, such as correction of items that are deducted as interest or salary, but are in fact payment of dividends, are not changes in method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(b).

If the accounting practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the tax year in which the taxable income is reported, it involves timing and therefore is considered a method of accounting. Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 799 (11th Cir. 1984). Where the correction of an erroneous treatment results in a change in accounting method, the requirements of section 446(e) are applicable. First National Bank of Gainesville v. Commissioner, 88 T.C. 1069, 1085 (1987). A taxpayer which changes its method of accounting on the basis of which it keeps its books must, prior to changing to a different method, secure the consent of the Commissioner. Section 446(e); Treas. Reg. § 1.446-1(e)(2)(i). Consent must be secured regardless of whether the method a taxpayer is changing is proper or permitted. Treas. Reg. § 1.446-1(e)(2)(i); Commissioner v. O Liquidating Corp., 292 F.2d 225 (3d Cir. 1961), cert. denied, 368 U.S. 898 (1961); Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989) (“Correcting an error in the selection of accounting methods, however, is not exempted from the consent requirement.”); Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500, 511 (1989) (“A change in method of accounting occurs even when there is a change from an incorrect to a correct method of accounting.”)

ANALYSIS:

The treatment of the $x1 payment as either a section 197 intangible (amortized over 15 years) or as a section 1234 option payment (deduction in year incurred) affects the timing of the deduction over the life of S’s purchase. S’s original treatment, as a section 197 intangible, resulted in amortization of 1/15 of the $x1 in Year 3. Presumably, S used identical treatment in 1995. S now wants to treat the $x1 payment as deductible in the year paid, Year 3, pursuant to section 1234. Thus, the taxpayer is changing the timing of the tax year in which expenses and income are reported, although not changing the lifetime income of the taxpayer. Accordingly, S is changing a method of accounting.

Because S is changing its method of accounting, it must secure the consent of the Commissioner to make its change. S is attempting an unauthorized retroactive change from one method of accounting (treatment as section 197 intangible) to another method (treatment as section 1234 option, deductible when paid) without securing the permission of the Commissioner under the provisions of I.R.C. § 446(e) and the regulations thereunder. Under the Code and regulations, the Commissioner may deny such a change in method of accounting.

> In addition, consent is required when a taxpayer, in a court proceeding, retroactively attempts to alter the manner in which he accounted for an item on his tax return. If the alteration constitutes a change in S's method of accounting, S cannot prevail if consent for the change has not been secured.

Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 682 (1980), supplemented by 82 T.C. 122 (1984) (citations omitted). See also Pacific Enterprises & Subsidiaries, 101 T.C. 1, 19-20 (1993).

V AND Z

ISSUES:

1. Whether the anti-churning rules, pursuant to section 197(f)(9), apply to the intangible assets S acquired from V.

2. Whether the anti-churning rules, pursuant to section 197(f)(9), apply to the intangible assets S acquired from Z.

CONCLUSION:

1. Given the facts that we have received, we can not determine, at this time, if the anti-churning rules will prevent S from deducting certain section 197 intangible

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assets (e.g., goodwill and going concern) that were acquired from V. Further factual development is needed on this issue.

2. Yes, it appears that the anti-churning rules prevent S from deducting the section 197 intangible assets acquired from Z. The facts we received show that S held and used these intangibles assets during the tainted period as set out in section 197(f)(9).

FACTS:

1. V

Based upon the facts we received, as of Date 8, U, a limited partnership, owned V. Also as of Date 8, both U and W, a corporation, were affiliates of WW. W was a wholly owned subsidiary of S. On Date 8, U sold the assets of V for $x5 to W. S allocated $x6 of the purchase price to intangible assets. On its returns for the taxable Year 2, S amortized the intangible assets under section 197 and deducted approximately $x7 as an amortization expense.

2. Z

Based upon the facts we received, on Date 9, S, X and several formed a limited partnership called Y. X was the general partner and the limited partnership interests were owned by certain . S was the special limited partner.

On Date 10, Y became the owner and operator of a facility in State 2 which had been owned and operated by XX, an affiliate of S until Date 10. Also on Date 10, Y became involved with financing and building a replacement facility in State 2. S contributed certain assets, including the facility operating license, and the use of the facility land, building and equipment to Y on Date 10.

After the opening of the replacement facility, S was responsible for selling the old facility building and land, paying all costs associated with the sale and would

receive the proceeds of the sale. Until these events occurred, S was to retain the risk of ownership of the old building and equipment.

On Date 11, Y entered into an asset purchase agreement with Z, an affiliate of S. Z would buy the general partner's and the limited partners' interests in the assets and assume all liabilities of the and its affiliates as of the closing date for $x8.

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The asset purchase agreement provided for S's interest in the property to continue uninterrupted . The special limited partner, S, received no proceeds from the transaction. Section 1.7 of the agreement reads:

> Buyer and S acknowledge and agree that the entire purchase price shall be distributed by Seller to the partners of Seller other than S, its affiliates, or successors in interest, and S and Buyer waive any claim to any part of the purchase price. In addition, the Buyer shall assume the Assumed Liabilities.

Section 3 of the agreement reads:

> Buyer acknowledges that S, an affiliate of Buyer, was the owner of the facility prior to its acquisition by seller and that at all times during Seller's ownership of the facility, S has been the manager and operator thereof, pursuant to the terms of the Management Agreement.

On its federal income tax return for the taxable year ended Date 12, S amortized the intangible assets under section 197 and deducted $x9 as an amortization expense.

LAW:

Section 197(a) allows an amortization deduction for the capitalized costs of an amortizable section 197 intangible. The deduction is allowed on a straight-line basis over a 15-year period. In general, an amortizable section 197 intangible is a:

1. Section 197 intangible (i.e., goodwill, going concern value, workforce in place, information base, customer based, supplier based, covenants not to compete, franchises, trademarks, trade names, licenses, patents and etc.)

2. Acquired after August 10, 1993 (or after July 25, 1991 if a valid retroactive election has been made)

3. Held in connection with the conduct of a trade or business or an income-producing activity described in section 212

4. Which is not created by the taxpayer.

Section 197(f)(9) sets forth anti-churning rules to limit the application of section 197. Under the authority of section 197(f)(9), the regulations contain anti-churning rules to prevent taxpayers from converting existing goodwill, going concern value, and other section 197 intangibles for which a depreciation or amortization deduction would not have been available prior to the Omnibus Budget Reconciliation Act of 1993, into amortizable section 197 intangibles. Pursuant to section 197(f)(9)(A) and Proposed Treas. Reg. , the anti-churning rules apply if the previously nonamortizable section 197 intangible was acquired by a taxpayer after August 10, 1993 (or July 25, 1991 if a valid retroactive election has been made) and any one of the following applies:

> (I) the taxpayer or related person held or used the intangible asset or interest therein at any time during the transition period (i.e, between July 21, 1991 and August 10, 1993);
>
> (ii) the taxpayer acquired the intangible from a person that held the intangible at any time during the transition period (i.e, between July 21, 1991 and August 10, 1993); and, as part of the transaction, the user of the intangible does not change; or
>
> (iii) the taxpayer grants the right to use the intangible to a person (or a person related to that person) that held or used the intangible at any time during the transition period.

For purposes of the anti-churning rules, parties are related if 1) they bear a relationship specified in sections 267(b) or 707(b)(1), but with a 20 percent threshold substituted for the 50 percent threshold for those sections; or 2) the parties are engaged in trades or businesses under common control within the meaning of section 41(f)(1). I.R.C. § 197(f)(9)(C)(i). In addition, parties are considered related if the relationship exists either immediately before or after the acquisition of the intangible asset transferred. I.R.C. § 197(f)(9)(C)(ii).

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ANALYSIS:

1. V

Based upon the facts we received, at this time, we can not determine whether the anti-churning rules under section 197(f)(9) would apply to the intangible assets acquired from the V acquisition. Further factual development is necessary to show what type of related party affiliation U had with S. In other words, we do not know if S's relationship with U meets the related party 20 percent threshold test as set out in sections 197(f)(9)(C)(i) and (ii). Additionally, the facts do not indicate whether U actually held and used the subject intangible assets during the tainted period that began on July 25, 1991. Thus, if it can be established that U met the 20 percent test, and also that U held and used the property during the tainted period, we will conclude that S is not entitled to the section 197 amortization deductions reported on its Year 2 tax return for goodwill, going concern and other intangibles not amortizable under prior law. See I.R.C. § 197(f)(9)(A). The anti-churning rules are designed to prevent related parties from taking advantage of the amortization provisions of section 197 by converting nonamortizable intangibles (under prior law) into amortizable intangibles without changing the ultimate user of the acquire assets.

2. Z

Based upon the facts we received, for purposes of the anti-churning rules, it appears that S "held and used" the intangible assets acquired in State 2 during the tainted period (July 21, 1991 through August 10, 1993). Section 3 of the Purchase Agreement, in fact, specifically notes that S was "the manager and operator" of these assets in Z during this time frame. This mere fact alone that S used and held the intangible asset during the tainted period prevents S from claiming an amortization expense on its 1994 tax return for goodwill, going concern and other intangibles not amortizable under prior law. The anti-churning rules are designed to prevent taxpayers from taking advantage of the amortization provisions of section 197 by converting nonamortizable intangibles (under prior law) into amortizable intangibles without changing the ultimate user of the acquire assets.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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If you have any further questions about this advice, please contact this office at (202) 622-78340.

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By: ___________________________

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