



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
December 20, 1998

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

DISTRICT COUNSEL

ATTN:

FROM:

DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated
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:

T	=
U	=
V	=
W	=
\$x2	=
\$x3	=
\$x4	=
\$x5	=
\$x6	=
\$x7	=
Year 1	=
Year 2	=

Date 1 =
Date 2 =
Date 3 =

ISSUE:

Should the Intangibles Settlement Initiative (“ISI”) be applied in this case?

CONCLUSION:

Based upon the information provided, the concern raised by Appeals regarding the common relationship of the parties raises doubts as to whether this was an arm’s length transaction. The ISI should not be applied in this case until the taxpayer and the Service agree upon a purchase price for the transaction. The remaining concerns raised have no bearing on whether the ISI should be applied in this case.

FACTS:

Pursuant to an Asset Purchase Agreement, dated Date 1, T acquired certain assets of U, a division of W. T also acquired certain assets of V, a wholly owned subsidiary of W. T’s representative has stated that the purchase price was \$X6. The purchase was made with a combination of cash, stock and cancellation of various notes. Based upon appraisals rendered at or about the time of the acquisition, T, the subject taxpayer made the estimates of fair market value as follows: engineering drawings from U and V \$x2 and computer software from V \$x3. The Service’s redetermination of allocable fair market value resulted in disallowances of claimed amortization deductions in the amounts of \$x4 and \$x5 for the taxable years ending Year 1 and Year 2 respectively. The Service issued at least two engineering and valuation reports, dated Date 2 and Date 3, concerning the value of the intangibles. The Service and T appear to agree that the tangibles are valued at \$x7.

Ultimately, Appeals issued a statutory notice of deficiency for the taxable years in question. After the deficiency notice was issued, there were discussions between T and Appeals concerning the availability of the ISI guidelines for this case. Appeals is concerned that the purchase price did not represent fair market value and hence that the ISI guidelines should not be applied without adjustment.

Appeals raised the following three specific concerns. One, the taxpayer did not include in its valuation the nonamortizable rights to be an original equipment manufacturer ("OEM") (i.e., T's right to portray itself as an OEM of W's replacement parts should be separately stated assets acquired from W). Two, the direct and indirect relationship between the parties involved in the asset purchase agreement indicate that the transaction may not have been at arm's length. Three, there may have been a cancellation of indebtedness on notes that were part of the transaction.

LAW AND ANALYSIS

As a result of the Supreme Court decision in Newark Morning Ledger, 507 U.S. 546 (1993), as well as legislative changes to the tax treatment of intangibles in the Omnibus Budget Reconciliation Act of 1993, the Internal Revenue Service announced a settlement initiative for most of the intangible issues pending in the controversy system. The initiative is an attempt to resolve disputes between the government and taxpayers regarding the fair market value attributable to intangibles with an attempt to avoid the cost and time of appraisals and experts needed to resolve these disputes. Under the settlement initiative, a taxpayer must agree to adjust the basis of its amortized intangibles by the greater of a 50 percent cost recovery adjustment or a 15 percent minimum concession adjustment.

Appeals has raised three concerns and district counsel has inquired as to whether these concerns should prevent the Service from offering the ISI. The first concern raised by Appeals is that the taxpayer did not include in its valuation the nonamortizable rights to be an original equipment manufacturer. In this case, there is not a dispute concerning the value of the tangibles acquired. Once the purchase price is established, that value less the value of the tangibles provides the amount attributable to the intangibles to be utilized in applying the ISI. The fact that the taxpayer did not separately list OEM in its valuation is inconsequential because the value attributable to the intangibles will remain the same and OEM will be allocated into the class with goodwill.

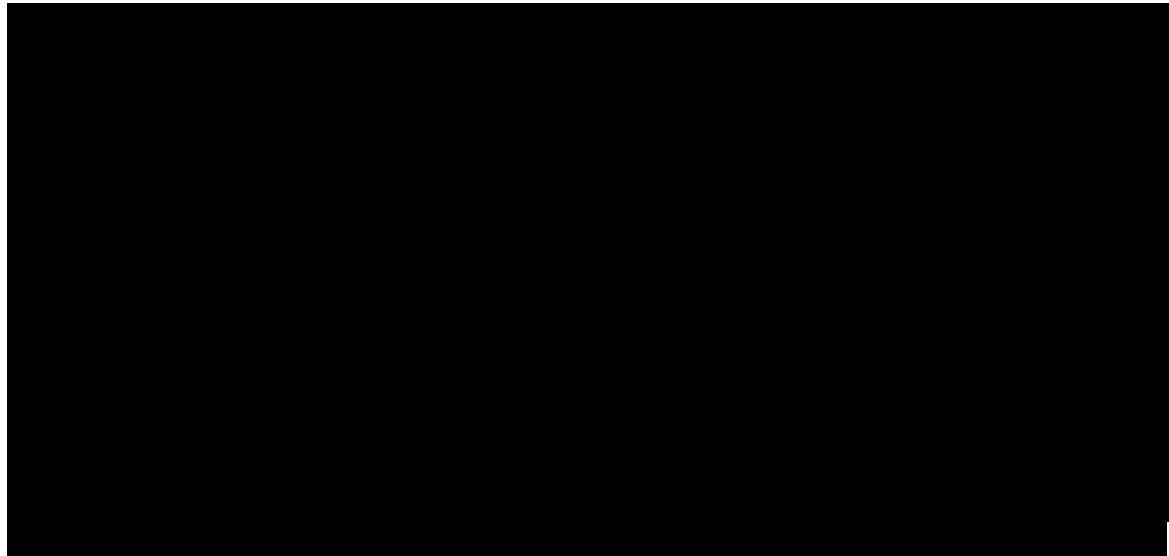
Appeals also states that the direct and indirect relationship between the parties involved in the asset purchase agreement indicates that the transaction may not have been at arm's length. Appeals implies that the amount paid by T was greater than fair market value so that greater depreciation benefits could be claimed. The facts indicate that there was some common ownership of T, W, and V at the time of the acquisition. The Service and T must first agree as to the amount of the purchase price before applying the ISI. The questions concerning the relationship between these parties may be resolved by a valuation of the business transferred. The issue is highly factual, and we clearly do not have enough facts to determine if

this was an arm's length transaction. Once the Service and T agree on the purchase price, the ISI may be applied to the value attributable to the intangibles.

The third concern raised by Appeals is that there may have been a cancellation of indebtedness on notes that were part of the transaction. While cancellation of indebtedness may have other tax implications, it should not bear on the Service's decision as to whether the ISI should be offered in a certain case. The fact that there may have been cancellation of indebtedness as part of the purchase price has tax implications for the entity which sold the assets and not the taxpayer at issue. See I.R.C. § 61(a)(12); I.R.C. § 108.

Based upon the information provided, we conclude that the first and third concerns have no bearing on whether the ISI should be applied in this case. Further, the ISI may only be applied after the second concern is resolved. The settlement initiative was implemented to fairly and effectively resolve claims concerning depreciation of intangibles. Specifically, the ISI is aimed at resolving disputes between the government and taxpayers regarding the fair market value attributable to intangibles with an attempt to avoid the cost and time of appraisals and experts needed to resolve these disputes. At the heart of this dispute is the value of the intangibles, the very issue which the settlement initiative is intended to resolve. Assuming that the Service and T can agree upon a purchase price, the ISI should be offered in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



In addition, we believe that your case also involves an I.R.C. § 482 issue. However, we have insufficient facts with which to make any determinations.

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DEBORAH A. BUTLER

By: _____

Branch
Field Service Division