OFFICE OF
CHIEF COUNSEL

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

March 8, 1999

CC:DOM:FS:IT&A

UILC: 165.13-00

Number: **199925006**
Release Date: 6/25/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

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

SUBJECT:

This Field Service Advice responds to your memorandum, dated November 25, 1998. 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:

X Corp. =
Y Corp. =
Z Corp. =
M =
N =
Insurance A =
States A =
Term C =
Term D =
Firm A =
Firm B =
Report A =
Report B =
A% =
B% =
$C =

$D =

ISSUES:

1. Whether the entities properly claimed abandonment losses with regard to their subscriber-based intangible and assembled workforce .

2. If abandonment losses were properly claimed on either asset, the amount of the loss was properly calculated.

CONCLUSIONS:

1. The entities may not deduct abandonment losses under I.R.C. § 165 with regard to either their subscriber-based intangible and assembled workforce .

2. If abandonment losses were properly claimed on either asset, we agree with the agent's criticisms of the calculation of the amount of the loss.

FACTS:

OVERVIEW -

Z Corp., dba X Corp. and Y Corp., collectively the taxpayers, were M entities incorporated in their respective states to provide Insurance A and related services. They use the accrual method of accounting and using a calendar taxable year. Y Corp. has merged with the M organizations in States A and is now known as N. The taxpayers offer group policies to employers and individual policies to individuals. In addition, they provide administrative services to certain other types of medical programs, such as Medicare.

X Corp. and Y Corp. were formerly tax exempt entities under section 501(c)(3), as were other M entities.

To determine their stepped-up basis under the transitional rule, X Corp. and Y Corp. hired outside accounting firms to value certain of their intangible assets. Based on these valuations and other computations performed in connection with such valuations, X. Corp. and Y Corp. have filed claims for refunds alleging additional loss deductions attributable to the termination of subscribers, employees and contracts with providers, in regard to the subscriber based intangible, assembled workforce, and provider base intangible, respectively, under I.R.C. §165. X Corp.’s claims cover Term C . Y Corp.’s claims filed thus far cover Term D.

The terminations of subscribers resulted from normal and routine cancellations and nonrenewals. That is, employers and individuals dropped plans, lost coverage because of nonpayment of premiums, changed plans, and changed jobs. The losses were not the result from X Corp.’s or Y Corp.’s withdrawal from a line of business or the cancellation of a plan type or insurance product.

X CORP. -

X Corp.’s claim is based only on its subscriber base intangible. Subscribers are the individuals and employers contracting with X Corp. for Insurance A. Firm A performed a valuation of subscribers as of , and also calculated the amount of loss for each year. Firm A's report, known as Report A covers the fair market value of X Corp.’s subscriber base as of , and the loss in subscribers from Term C. Report A uses an income approach for its valuation.

A present value was calculated based on the discounted cash flow over the estimated useful lives of plans and individual enrollees using a A% discount rate.

. Report A determined that the fair market value of the subscriber list was $C as of . The discount rate of A% is derived from X Corp.’s weighted average cost of capital.

Y CORP. -

Y Corp.’s narrative portion of its claim refers to losses under section 165 “related to software, workforce in place, coverage of member subscribers and contractual expirations with provider organizations which were valued as of .” Although Y Corp.’s claim also covers expiration of provider contracts and software, the agent examining the claims indicates that, in fact, the loss amount is based on subscriber base and assembled workforce. Y Corp. has indicated to the agent that the narrative is protective. Since the only information available at this time concerns Y Corp.'s subscriber base and assembled workforce, our discussion is limited to those assets.

Y Corp.'s subscriber base and assembled workforce intangibles were valued by Firm B in Report B. It covered Y Corp.'s assembled workforce and subscriber base. Report B uses a discounted cash flow method to value the subscriber base and a "cost-to-create" method to value the workforce.

An "obsolescence factor" of B% was applied to the estimated costs on the theory that the workforce was B% through its useful life on average, although no empirical evidence for this assumption is cited. Report B places a value of $D on the workforce in place as of the valuation date.

<u>LAW AND ANALYSIS</u>:

ISSUE 1 - ABANDONMENT LOSS

Abandonment losses are deductible under I.R.C. § 165(a), which allows any loss sustained during the taxable year and not compensated for by insurance or otherwise.

The requirements for a loss are found in the regulations under section 165. Specifically, Treas. Reg. § 1.165-2(a) allows a loss incurred in a business and arising from the sudden termination of the usefulness of any nondepreciable property, in a case where the business is discontinued or where the property is permanently discarded from use therein, as a deduction under section 165(a) for the taxable year in which the loss is actually sustained.

Treas. Reg. §1.165-1(b) requires that, to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, and fixed by identifiable events. Normally, an abandonment loss requires (1) an intention on the part of owner to abandon the asset, and (2) an affirmative act of abandonment. A.J. Industries, Inc. v. United States, 503 F.2d 660, 670 (9th Cir. 1974); Citron, 97 T.C. at 209; CRST, Inc. v. Commissioner, 92 T.C. 1249, 1257 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990).

It is clear that intangible assets may be the subject of an abandonment loss. Parmelee Transportation Co. v. United States, 351 F.2d 619 (Ct. Cl. 1965). See Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220 (1959), acq. 1973-2 C.B. 2; Solar Nitrogen Chemicals, Inc. v. Commissioner, T.C. Memo. 1978-486.
The most essential issue in the present case is the resolution of whether subscribers or employees can be abandoned individually; or whether the individual components must be treated as part of an indivisible whole, i.e., the subscriber-based intangible or assembled workforce, which itself is the only proper subject for an abandonment loss.

There have been numerous decisions holding that assets indistinguishable from the subscriber-based intangible and assembled workforce involved in the present case are single indivisible assets and not an aggregation of individual assets. Ralph W. Fullerton Company v. United States, 550 F.2d 548 (9th Cir. 1977)(customer list); Sunset Fuel Co. v. United States, 519 F.2d 781 (9th Cir. 1975); Skilken v. Commissioner, 420 F.2d 266 (6th Cir. 1969)(contracts for vending machine locations); Meredith Publishing Co. v. Commissioner, 64 F.2d 890 (8th Cir. 1932), cert. denied, 290 U.S. 646 (1933) (magazine subscription list); Golden State Towel and Linen Service, 373 F.2d 938 (Ct. Cl. 1967)(customer list); Ithaca Industries, Inc. v. Commissioner, 97 T.C. 253 (1991), aff'd,17 F.3d 684 (4th Cir.), cert. denied, 513 U.S. 821 (1994)(workforce); Manhattan Co. of Virginia v. Commissioner, 50 T.C. 78 (1968), acq. 1974-2 C.B. 3 (customer list); Boe v. Commissioner, 35 T.C. 720 (1962), aff'd, 307 F.2d 339 (9th Cir. 1962)(medical service contracts); Thrifticheck Service Corp. v. Commissioner, 33 T.C. 1038 (1960), aff'd, 287 F.2d 1 (2d Cir. 1961)(customer contracts) ; Anchor Cleaning Service v. Commissioner, 22 T.C. 1029 (1954), nonacq. on another issue, 1958-2 C.B. 9 (customer list); Commercial National Insurance Co. v. Commissioner, 12 B.T.A. 655 (1928)(insurance policyholders); Nickisch v. Commissioner, T.C. Memo. 1984-275 (customer list); Illinois Cereal Mills, Inc. v. Commissioner, T.C. Memo. 1983-469, aff'd, 789 F.2d 1234 (7th Cir.), cert. denied, 479 U.S. 995 (1986) (customer list).

Some of these cases directly held that the loss of an individual component of the indivisible asset could not be separately deducted as an abandonment loss. Thus, for example, as in the present case, taxpayers could not deduct amounts attributable to each customer the taxpayer lost. Ralph W. Fullerton, supra; Sunset Fuel, supra; Golden State Towel, supra; Anchor Cleaning, supra; Illinois Cereal Mills, supra; see Skilken supra; Boe, supra.

The facts of the present case are clearly distinguishable from the circumstances where the taxpayer abandons a portion the indivisible asset which has distinct transferrable value that is reasonably severable from the whole. The pivotal case on this issue is Metropolitan Laundry Co. v. United States, 100 F. Supp. 803 (N.D. Cal. 1951), where the taxpayer was permitted an abandonment loss on a portion of a customer list that was attributable to a specific geographic area. The taxpayer had purchased the customer lists of several laundry businesses in San Francisco and Oakland. During World War II, the government seized the taxpayer's San Francisco plant for military purposes. After the war, the taxpayer had trouble reestablishing its business and abandoned its San Francisco routes while it continued its operations in Oakland. The district court recognized that "a list of customers...is not to be regarded as an aggregation of disconnected individual subscribers" and were instead treated as "unitary structures irrespective of incidental fluctuations or alterations." Metropolitan Laundry, 100 F. Supp. at 805. However, the court noted that a taxpayer could "dispose of its business in a particular area or in respect to a particular product or service along with incidental goodwill without abandoning its entire business." Id. at 806. "And...so long as the business and the goodwill disposed of may be assigned a distinct transferable value, the transaction may properly be recognized, for tax purposes, as a closed one." Id. at 806-07. The court found that the costs attributable to the abandoned San Francisco customer lists met this test and were deductible.

Similarly, Massey-Ferguson held that the taxpayer could deduct the abandonment of a line of business it had purchased from another party and operated at a distinct location, even though the taxpayer continued to manufacture similar products under a different trade name at another location. See also Parmelee Transportation; Strauss v. United States, 199 F. Supp. 845 (W.D. La. 1961). The taxpayers in the present case have not abandoned a segment of their business that is analogous to either Metropolitan Laundry or Massey-Ferguson. The distinction between the facts similar to the present case from those found in Metropolitan Laundry has been explicitly recognized by the courts. See Skilken, 420 F.2d at 270; Anchor Cleaning, 22 T.C. at 1033-35.

Our conclusion regarding the claimed abandonment losses is left unchanged by the Supreme Court's decision in Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993), where the Supreme Court held that a comparable asset, a newspaper subscriber list, was amortizable. In coming to this conclusion, the Court reaffirmed the "mass asset" or "indivisible asset" rule that has underscored many of the intangible asset cases we have cited.

> The rule provides that certain kinds of intangible assets are properly grouped and considered as a single entity; even though the individual components of the asset may expire or terminate over time, they are replaced by new components, thereby causing only minimal fluctuations and no measurable loss in the value of the whole.

Newark Morning Ledger, 507 U.S. at 557. The Court also quoted a portion of Golden State Towel, 373 F.2d at 944, as the "usually accepted definition of a mass asset." 507 U.S. at 557. The quote included the following:

> The whole is equal to the sum of its fluctuating parts at any given time, but each individual part enjoys no separate capital standing

> independent of the whole, for its disappearance affects but does not interrupt or destroy the continued existence of the whole.

Newark Morning Ledger, 507 U.S. at 557-58, quoting, Golden State Towel, 373 F.2d at 944. From this, the Court concluded that "[t]he mass-asset rule prohibits the depreciation of certain customer-based intangibles because they constitute self-regenerating assets that may change but never waste." Newark Morning Ledger, 507 U.S. at 558.

The definition of the mass asset rule quoted from Golden State Towel also stated that its "customer list is...indistinguishable from - and the principal element of - goodwill, whose ultimate value lies in the expectancy of continued patronage through public acceptance." Newark Morning Ledger, 507 U.S. at 558, quoting, Golden State Towel, 373 F.2d at 944. The Supreme Court traced the precedents linking intangibles to goodwill. It then discussed the argument that the intangibles were not depreciable because they were indistinguishable from goodwill, which itself is not depreciable. It noted that traditionally goodwill was not depreciable because it "does not suffer wear and tear, does not become obsolescent, is not used up in the operation of the business." Newark Morning Ledger, 507 U.S. at 565, quoting, Red Wing Malting Co. v. Willcuts, 15 F.2d 626, 633 (8th Cir. 1926), cert. denied, 273 U.S. 763 (1927). The Court concluded that:

> It must follow that if a taxpayer can prove with reasonable accuracy that an asset used in the trade or business or held for the production of income has value that wastes over an ascertainable period of time, that asset is depreciable under § 167, regardless of the fact that its value is related to the expectancy of continued patronage.

Newark Morning Ledger, 507 U.S. at 567. The Court found the subscription list amortizable because it met these criteria. Any relation it might have to goodwill was irrelevant.

In order to understand the impact of Newark Morning Ledger on the present case, it is important to note that some of the cases we have cited regarding whether an intangible asset could be abandoned piecemeal also addressed whether the asset could be amortized. See, e.g., Ralph W. Fullerton, supra; Manhattan Co., supra; Thrifticheck, supra; Illinois Cereal Mills, supra. These were alternative arguments made by the taxpayer which were clearly distinct. The holding of Newark Morning Ledger only addresses the second issue, i.e., amortization. However, the rationale of Newark Morning Ledger in its discussion of the "mass asset" rule relates directly to the issue of abandonment of intangible assets like those in the present case .

First, it is clear under Newark Morning Ledger that, if an intangible asset self-regenerates, the mass asset rule applies to have the asset treated indivisibly.

Workforce and subscriber lists are clearly self-regenerating. Further, if the assets are self-regenerating, there is an argument that the asset as a whole is not abandoned so long as the taxpayer remains in business.

On the other hand, as indicated by the quotation from Golden State the mass asset rule has also been linked to goodwill in the context of abandonment. Since the Supreme Court rejected the importance of this link in the context of amortization, it is important to examine the importance of the link in the context of abandonment. The issue for abandonment losses is summarized in Massey-Ferguson, which states,

> some confusion has developed ... as to whether there can be an abandonment of a part of "goodwill" as long as the business continues to operate....However, there seems to be no real disagreement in the cases; at least now, it seems to be generally recognized that if there is a clearly identifiable and severable asset, its abandonment entitles the taxpayer to a loss deduction.

59 T.C. at 225, (citations omitted). Thus, while goodwill cannot be amortized, it can be abandoned under the same test as is applicable to the intangible asset. See Metropolitan Laundry, 100 F. Supp. at 806; Solar Nitrogen Chemicals, supra. Therefore, the traditional link to goodwill in the context of abandonment losses does raise the same problems as in the context of amortization, where goodwill is still not amortizable.

Further, the issue of whether an asset is indivisible has also been seen to be ultimately severable from the goodwill issue. Thus, Thrifticheck, 33 T.C. at 1047, found that "wholly aside from any goodwill element...the acquisition of the 200 contracts [with customers] should be treated as the acquisition of a single asset." See also Ralph W. Fullerton, at Id.; Manhattan Co., 50 T.C. at 87; Boe, 35 T.C. at 726.

Lastly, that partial abandonment and amortization are alternative arguments demonstrates that their practical results are almost the same. In one instance, the taxpayers were attempting to recognize their actual loss and in the other they were estimating that loss through the use of amortization. Thus, allowing the taxpayers to deduct portions of these assets each year amounts to the allowance of amortization, without meeting the prerequisites therefor.

So long as the intangible asset is deemed to be a whole rather than the sum of any of its parts the ability to deduct any part of it as an abandonment loss rests ultimately on whether there has been a recognition event. Under facts like the present case, courts have found that the loss of any individual component only reduces the value of the whole asset. Sunset Fuel, 519 F.2d at 783; Manhattan Co., 50 T.C. at 87; Thrifticheck, 33 T.C. at 1047. The mere diminution in value of property is not enough to establish an abandonment loss. Kraft, Inc. v. United States, 30 Fed. Cl. 739, 785-86 (1994); Lakewood Associates v. Commissioner, 109 T.C. 450, 456 (1997). See United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398, 401 (1927). Specifically, diminution in value fails to satisfy the requirement under the regulations that a loss be “evidenced by closed and completed transactions, fixed by identifiable events.” Sunset Fuel, 519 F.2d at 783. See S.S. White Dental, at Id. Instead, the taxpayer normally must wait until the entire indivisible asset is abandoned before it can take any deduction under section 165(a). See Massey-Ferguson, 59 T.C. at 226-27; Anchor Cleaning; 22 T.C. at 1035; Nickisch v. Commissioner, T.C. Memo. 1984-275.

Further, as indicated above, the intention to abandon standing alone is not sufficient to establish a recognition event; instead, there must be an affirmative act of abandonment. See Brountas v. Commissioner, 692 F.2d 152 (1st Cir. 1982), cert. denied, 462 U.S. 1106 (1983); Beus v. Comissioner, 261 F.2d 176, 180 (9th Cir. 1958); Citron, 97 T.C. at 210; Zurn v. Commissioner, T.C. Memo. 1996-386. As a result, there is arguably an inherent requirement for an abandonment loss that the taxpayer, rather than some other party, take the action to abandon permanently the property in question. Further, an abandonment does not result simply from cessation of use. Beus, at Id.; Citron, at Id.

Thus, participation in a government program which required the taxpayer to discontinue his dairy operation, was not an abandonment where there was no showing of the irrevocable intent to abandon or never use the property again. Strandley v. Commissioner, 99 T.C. 259 (1992), aff'd on another issue, 73 AFTR 2d (RIA) 2118 (9th Cir. 1994). Similarly, in denying an abandonment loss for the individual members of a customer list, the court in Anchor Cleaning, 22 T.C. at 1035, noted that the taxpayer had not “put itself in a position where it would be unable to solicit or to serve such customers should they later decide to return to it.” Golden State Towel, 373 F.2d at 943, also relied upon this language in denying an abandonment loss for the loss of individual customers. There is no showing in the present case that, given the chance, the entities would not become similarly involved with these subscribers and employees or that the taxpayers were in any way prevented from doing so. Similarly, other cases have held that the actions of another party only affect the value of the property the taxpayer continues to hold. See CRST, 92 T.C. at 1259-61; Consolidated Freight Lines, Inc. v. Commissioner, 37 BTA 576 (1938), aff’d, 101 F.2d 813 (9th Cir. 1939); Beatty v. Commissioner, 46 T.C. 835 (1966).

Lastly, the way in which the taxpayers have valued their assets may argue against the abandonment of individual subscribers or employees. As stated in Sunset Fuel, 510 F.2d at 783, “the indivisible asset rule prevents a loss deduction when the nature of the purchased asset is such that the individual assets cannot be accurately valued." Thus,

> Sunset Fuel made clear that valuation of customer accounts by resort to a formula applied indiscriminately to all accounts does not sufficiently establish the portion of the purchase price allocable to the individual accounts so as to avoid the application of the mass [i.e., indivisible] asset rule. Indeed, resort to a formula was felt to be an indication that the individual value of the accounts cannot be satisfactorily ascertained.

Ralph W. Fullerton, 550 F.2d at 550. Similar conclusions are reached in Skilken, 420 F.2d at 270; Golden State Towel, 373 F.2d at 943; and Boe, 35 T.C. at 725. Compare Commissioner v. Seaboard Finance Corp., 367 F.2d 646 (9th Cir. 1966), where the taxpayer was able to establish the cost of a particular account lost.

ISSUE 2 - VALUATION

We understand that the examination of taxpayers' valuation is currently assigned to an IRS Agent Engineer [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

By: ______________________
CLIFFORD M. HARBOURT
Senior Technician Reviewer
Income Tax and Accounting Branch