INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director

Taxpayer's Name:
Taxpayer's ID Number:
Taxpayer's Address:

Tax Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Seller =

Subsidiary A =

Subsidiary B =

Station A =

Station B =

Type A Contracts =

Type B Contracts =

Type C Contracts =

ISSUES:

1. The first issue is whether the newly-formed subsidiaries of the Taxpayer, an affiliated group that files a consolidated return, are considered to be in existence for the Taxpayer's entire consolidated return tax year, regardless of when the subsidiaries were formed during the year, for purpose of the short taxable year rules in Rev. Proc. 89-15, 1989-1 C.B. 816.

2. The second issue is whether certain license payments under the Contracts assumed by the Taxpayer's subsidiaries in the acquisition of television business assets are "assumed liabilities" under §§ 461 and 1060 of the Internal Revenue Code that must be taken into account as part of the purchase price. If these payments are assumed liabilities, must they be capitalized into the basis of the Contracts and amortized as section 197 intangibles under § 197(d)(1)(C)(iii)?

CONCLUSIONS:

1. The Taxpayer's newly-formed subsidiaries are deemed to have been in existence for the entire consolidated return tax year, even if that would cause the recovery period of property placed in service by the newly-formed subsidiaries to begin before the subsidiaries were formed.

2. To the extent a Taxpayer's subsidiary was obligated to make payments under the Type A Contracts, payments under the Type B Contracts for runs that had been delivered at the time of the acquisition, and payments under the Type C Contracts for episodes that had been delivered at the time of the acquisition, the Taxpayer subsidiary incurred liabilities within the meaning of § 461. These liabilities are treated as assumed liabilities. Each Taxpayer subsidiary must include the liabilities it assumed in the amount of consideration to be allocated under § 1060. At the time of the acquisition, the Taxpayer's subsidiaries did not incur any liabilities for undelivered episodes under the Type C Contracts or for each undelivered run under the Type B Contracts because there was no fixed liability and because economic performance had yet to occur.

The Contracts constitute an interest in a film for purposes of § 197(d)(1)(C)(iii). Thus, the fair market value of each amortizable section 197 intangible under § 197(d)(1)(C)(iii) is the fair market value paid by a subsidiary for the Contract plus the amount of any associated assumed liabilities.

FACTS:

The Taxpayer uses the accrual method of accounting. Subsidiary A and Subsidiary B were formed by the Taxpayer as wholly-owned subsidiaries in for the purpose of acquiring, owning, and operating the broadcast television assets of Station A and Station B (the "Stations"), respectively. The Taxpayer had originally entered into a contract with the Seller to acquire these properties on , but assigned its rights under the contract to its subsidiaries in an Assignment of Rights and Obligations dated . According to the Taxpayer, the closings of Subsidiary A's and Subsidiary B's acquisitions of Station A and Station B took place on , and , respectively.

For and , the Taxpayer claimed aggregate depreciation deductions of $ and $, respectively, for the Station A tangible property acquired by Subsidiary A in , and $ and $, respectively, for the Station B tangible property acquired by Subsidiary B in . The Taxpayer calculated its depreciation deductions for the tangible property by using the half-year convention under § 168(d)(4)(A) of the Code for the personal property placed in service by the subsidiaries in and the mid-month convention under § 168(d)(4)(B) for all real property placed in service by the subsidiaries in .

As part of the acquisitions of the Stations, the subsidiaries acquired from the Seller certain licensing agreements to broadcast syndicated television programs ("Contract" or "Contracts"). The Stations did not acquire any ownership interest in the programs themselves. The Contracts granted to the Stations the right to broadcast episodes of particular programs in their entirety in a specific geographical area. The Stations did not acquire title to the programs. The Contracts generally prohibited the Stations from broadcasting any episode without displaying the copyright notice of the licensor. Moreover, under the Contracts, the Stations generally were prohibited from sublicensing or relicensing the programs, or even copying or recording the programs.

According to the Taxpayer, each Contract specifies the number of episodes of a particular television series available for broadcast, the number of times each episode may be broadcast (referred to in the industry as the number of "runs"), the duration of the agreement, the price per episode, and the payment terms. A typical Contract required ratable payments over the term of the Contract, or a down payment of % to %, with the balance due in equal installments over the remaining term of the Contract. Generally, a licensee would not have any obligation to make payment to the licensor to the extent the programs or films were not made available.

The Contracts typically provide that an episode may be withdrawn from the license, or the Contract could be terminated, if (a) the episode is not released or does not continue in national syndication; (b) the licensor determines that the broadcast of the episode would infringe on the rights of others, violate law, or subject the licensor to litigation; or (c) the copyright covering the material upon which the episode was based expires. If an episode is withdrawn, the licensor generally has the right to substitute a comparable episode or extend the license term until the episode becomes available.

There are three basic types of Contracts. Under the Type A Contracts, licensed programming is provided to a Station prior to the first showing of an episode and is "libraried" by the station. That is, the Station retains actual physical possession of the licensed episode during the period of the Contract. Under the Type B Contracts, licensed episodes are provided to a Station in advance of each showing of an episode. The period in advance of which the episodes are provided to the Station ranged from days to weeks. Under the Type C Contracts, licensed episodes are provided to a Station by satellite on the day of broadcast. Subsidiary A and Subsidiary B treated the acquisitions as applicable asset acquisitions and each filed Form 8594, "Asset Acquisition Statement Under Section 1060," for each acquisition.

For Subsidiary A's acquisition of Station A assets on , the Taxpayer elected under § 1.197-1T(c) of the Temporary Income Tax Regulations to retroactively apply § 197 to all eligible section 197 intangibles acquired by the Taxpayer after July 25, 1991, and before August 11, 1993. Subsidiary B's acquisition of Station B occurred on , after August 10, 1993, the effective date of § 197.

Both Subsidiary A and Subsidiary B treated the Contracts as amortizable section 197 intangibles under § 197(c), and began to amortize the claimed fair market values of the intangibles over the 15-year period beginning with the month in which the intangibles were acquired. Thus, Subsidiary A claimed $ and $ in amortization deductions on its Contracts for and , respectively, and Subsidiary B claimed $ and $ in amortization deductions on its Contracts for and , respectively.

In addition, both subsidiaries treated the remaining payments under the Contracts in the following manner. For Contracts having a remaining term of one year or less as of the date of acquisition, the subsidiaries deducted the same amounts of license fees for both book and tax purposes. For Contracts having a remaining term of more than one year, the subsidiaries applied different expense methodologies for book and tax purposes. For book purposes, the license fees paid under the Contracts were expensed based on the sum-of-the-years-digits method, while for tax purposes, the license fees were expensed based on the number of runs in each year.

LAW AND ANALYSIS FOR ISSUE 1:

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) -- (1) of property used in the trade or business, or (2) of property held for the production of income.

Section 168(a) provides that except as otherwise provided in § 168, the depreciation deduction provided by § 167(a) for any tangible property shall be determined by using (1) the applicable depreciation method, (2) the applicable recovery period, and (3) the applicable convention.

Section 168(d)(1) provides that for purposes of § 168, except as otherwise provided in § 168(d), the applicable convention is the half-year convention. Section 168(d)(4)(A) defines the half-year convention as a convention that treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of the taxable year.

Section 168(d)(2) provides that in the case of (A) nonresidential real property, (B) residential rental property, and (C) any railroad grading or tunnel bore, the applicable convention is the mid-month convention. Section 168(d)(4)(B) defines the mid-month convention as a convention that treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of the month.

Section 168(d)(3)(A) provides that, except as provided in regulations, if during any taxable year -- (i) the aggregate bases of property to which § 168 applies placed in service during the last 3 months of the taxable year exceed (ii) 40 percent of the aggregate bases of property to which § 168 applies placed in service during the taxable year, the applicable convention for all property to which § 168 applies placed in service during the taxable year shall be the mid-quarter convention.

Section 1.168(d)-1(a) provides in part that, under § 168(d)(3)(A) , the mid-quarter convention applies to depreciable property (other than certain real property described in § 168(d)(2)) placed in service during a taxable year if the aggregate basis of property placed in service during the last three months of the taxable year exceeds 40 percent of the aggregate basis of property placed in service during the taxable year ("the 40-percent test"). Thus, if the depreciable property is placed in service during a taxable year that consists of three months or less, the mid-quarter convention applies to the property.

Section 1.168(d)-1(b)(5)(i) provides that in the case of a consolidated group (as defined in § 1.1502-1(h)), all members of the group that are included on the consolidated return are treated as one taxpayer for purposes of applying the 40-percent test. Thus, the depreciable bases of all property placed in service by members of a consolidated group during a consolidated return year are taken into account (unless otherwise excluded) in applying the 40-percent test to determine whether the mid-quarter convention applies to property placed in service by the members during the consolidated return year.

Section 1.168(d)-1(b)(5)(ii) provides that in the case of a corporation formed by a member or members of a consolidated group and that is itself a member of the consolidated group ("newly-formed subsidiary"), the depreciable bases of property placed in service by the newly-formed subsidiary in the consolidated return year in which it is formed is included with the depreciable bases of property placed in service during the consolidated return year by the other members of the consolidated group in applying the 40-percent test. If depreciable property is placed in service by a newly-formed subsidiary during the consolidated return year in which it was formed, the newly-formed subsidiary is considered as being in existence for the entire consolidated return year for purposes of applying the applicable convention to determine when the recovery period begins.

The Example in § 1.168(d)-1(b)(5)(iii) illustrates the provision in § 1.168-1(b)(5)(ii):

> Assume a member of a consolidated group that files its return on a calendar-year basis forms a subsidiary on August 1. The subsidiary placed depreciable property in service on August 5. If the mid-quarter convention applies to property placed in service by the members of the consolidated group (including the newly-formed subsidiary), the property placed in service by the subsidiary on August 5 is deemed placed in service on the mid-point of the third quarter of the consolidated return year (i.e., August 15). If the mid-quarter convention does not apply, the property is deemed placed in service on the mid-point of the consolidated return year (i.e., July 1).

Rev. Proc. 89-15, 1989-1 C.B. 816, provides guidance for computing depreciation allowances for tangible property under § 168 when the property is placed in service in a taxable year of less than 12 full months ("a short taxable year"). Under section 4.01(1)(a)(i) of Rev. Proc. 89-15, 1989-1 C.B. at 817, property subject to the half-year convention is deemed placed in service or disposed of on the mid-point of the taxable year in which the property is placed in service or disposed of. For a short taxable year that begins on the first day of a month or ends on the last day of a month, the taxable year, for purposes of § 168 , consists of the number of months in the taxable year. (For this purpose, if the short taxable year includes part of a month, the entire month shall, in general, be included in the number of months in the taxable year.) The mid-point of the taxable year is then determined by dividing the number of months in the taxable year by 2. For example, a short taxable year that begins on June 20 and ends on December 31 consists of 7 months and the mid-point of the taxable year is the middle of September. Property is treated as placed in service or disposed on this mid-point.

Under section 4.02 of Rev. Proc. 89-15, 1989-1 C.B. at 818, to determine the depreciation allowance for the first taxable year in the recovery period when the year is a short taxable year, the taxpayer must initially determine the depreciation attributable to the first recovery year. The depreciation attributable to the first recovery year is obtained by multiplying the taxpayer's basis in the property by the applicable depreciation rate. The depreciation allowance allocable to the first taxable year is then obtained by multiplying the depreciation attributable to the first recovery year by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be in service during the taxable year (taking into account the applicable convention) and the denominator of which is 12.

The District Director does not dispute that the Station A and Station B tangible personal property placed in service by Subsidiary A and Subsidiary B, respectively, qualify for the half-year convention under § 168(d)(1) . Nor does the District Director dispute that all members of the Taxpayer's affiliated group that are included on its consolidated return are treated as one taxpayer for purposes of applying the 40-percent test under § 1.168(d)-1(b)(5)(i) and that the Taxpayer is not required to use the mid-quarter convention under § 168(d)(3)(A) in . Rather, the District Director contends that the short taxable year rules in Rev. Proc. 89-15 apply in calculating the amount of depreciation allowable for the first recovery year that Subsidiary A and Subsidiary B acquired Station A and Station B, respectively, because in the subsidiaries were in existence for a taxable year of less than 12 full months.

However, the Example in § 1.168(d)-1(b)(5)(iii) demonstrates that property placed in service by a newly-formed subsidiary can be deemed placed in service under the half-year convention of § 168(d)(1) before the newly-formed subsidiary came into existence. In the example, the newly-formed subsidiary was formed on August 1. The consolidated group files its returns using a calendar year. If the half-year convention applies, the convention deems the property placed in service on the mid-point of the consolidated return year, which was July 1. The example concludes that the newly-formed subsidiary is entitled to six months of depreciation regardless of the fact that it was in existence for only five months. If the short taxable year rules of Rev. Proc. 89-15 applied, under section 4.01(1)(a)(i) of Rev. Proc. 89-15, the mid-point of the newly-formed subsidiary's taxable year would be the middle of October (5 months/2), not July 1.

The half-year and mid-quarter convention regulations in § 1.168(d)-1 were promulgated as a final regulation in 1992. If the regulations conflict with Rev. Proc. 89-15, the regulation controls. However, we see no conflict between § 1.168(d)-1 and Rev. Proc. 89-15. Rev. Proc. 89-15 does not address if and how the short taxable year rules apply to property placed in service by members of affiliated groups filing consolidated returns. Moreover, treating the newly-formed subsidiaries as in existence for the entire consolidated return tax year is consistent with the rule in § 168(i)(7)(B)(ii), which provides step-in-the-shoes treatment for transfers of depreciable property between members of an affiliated group filing a consolidated return. The Taxpayer could have acquired the Station A and Station B broadcast television property itself. Instead, the Taxpayer formed new subsidiaries to acquire the property. Consistent with the policy behind § 168(i)(7)(B)(ii), the allowable depreciation deductions for the property should be the same whether the Taxpayer or the subsidiaries acquired the property. If the subsidiaries were separate divisions of the Taxpayer, not separate corporate affiliates, the Taxpayer would be entitled to six months of depreciation by use of the half-year convention under § 168(d)(1).

In the Taxpayer and its affiliates were not required to use the mid-quarter convention under § 168(d)(3)(A) for depreciable property placed in service during that year. The Taxpayer was entitled to use the half-year convention under § 168(d)(1). Accordingly, for purposes of calculating the allowable amount of depreciation using the half-year convention, Subsidiary A and Subsidiary B are deemed to have been in existence for the Taxpayer's entire consolidated return tax year. The Taxpayer's application of the half-year convention to its consolidated return year was proper.

LAW AND ANALYSIS FOR ISSUE 2:

The District Director contends that the license payments assumed by the subsidiaries under the Contracts are "assumed liabilities" for purposes of § 461, which must be included in the consideration paid to acquire Station A and Station B broadcast television assets and allocated under § 1060 . The District Director also contends that these assumed liabilities must be capitalized into the Contracts and amortized as section 197 intangibles under § 197(d)(1)(C)(iii). On the other hand, the Taxpayer argues that the obligations to pay the license fees under the Contracts were not assumed liabilities at the time the subsidiaries acquired the Stations because the licensors had the right to withdraw programming. In addition, the Taxpayer argues that the Contracts are supplier-based contracts for purposes of the economic performance rules under § 461(h) and § 197.

Section 461 governs the determination of when a liability is incurred and taken into account. For accrual method taxpayers, a liability is incurred and taken into account in the year in which (1) the liability is "fixed" -- that is generally the year in which the liability becomes an enforceable obligation; and (2) the amount of the liability can be determined with reasonable accuracy. In addition, § 461(h) specifies that a liability is not incurred any earlier than the year in which economic performance occurs. Once a liability is incurred under § 461 the characterization of that liability is made as either a deductible expense or a capital expenditure. Section 1.461-1(a)(2)(i). For the reasons described below, we conclude that a liability was incurred for the Type A Contracts, the delivered but not paid for runs under the Type B Contracts, and the delivered but not paid for episodes under the Type C Contracts as of the acquisition date. However, a liability was not incurred as of the acquisition date for the Type C Contracts to the extent episodes had not been delivered and the Type B Contracts to the extent runs had not been delivered as of that date because the liabilities under those contracts were not fixed and economic performance had not occurred.

The obligations under the Type C Contracts to the extent episodes were not delivered and the Type B Contracts to the extent runs were not delivered as of the acquisition date are not fixed because those agreements are executory. Under the agreements, the Stations have no obligation to make payments unless the syndicator provides programming. Executory contracts are not a fixed liability within the meaning of § 461. See United States v. General Dynamics, 481 U.S. 239 (1987) (filing of insurance claims is necessary to fix liability even though services may already have been performed).

In addition, the obligations under the Type C Contracts to the extent episodes were not delivered and the Type B Contracts to the extent runs were not delivered as of the acquisition date have not satisfied the economic performance requirements of § 461(h). Under those agreements, the Stations have the right to receive syndicated television programming. Section 1.461-4(d)(2)(i) provides generally that if a liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided. Accordingly, to the extent episodes for the Type C Contracts or runs for the Type B Contracts had not been delivered as of the acquisition date, the economic performance requirement will be satisfied no earlier than when each episode (Type C Contracts) or run (Type B Contracts) is provided to the Stations.

In contrast, the obligations under the Type A Contracts, the Type B Contracts to the extent runs were delivered as of the acquisition date, and the Type C Contracts to the extent episodes were delivered as of the acquisition date are properly treated as incurred under § 461. Delivery of the episodes (Type A Contracts and Type C Contracts) and runs (Type B Contracts) fixed the liabilities and also satisfied the economic performance requirement.

Under § 1060, an applicable asset acquisition is an acquisition of a trade or business in which the purchaser's basis is determined wholly by the consideration paid. Section 1.1060-1T(c)(1) defines the purchaser's consideration as the cost of the assets. Section 1012 provides that, unless otherwise provided, the basis of property shall be its cost. Liabilities that a taxpayer assumes in connection with the acquisition of property are generally considered part of the taxpayer's cost. The amount paid generally includes liabilities that encumber the property when acquired or liabilities assumed by the taxpayer in acquiring the property. See Crane v. Comm'r, 331 U.S. 1 (1947).

Assumed liabilities are part of the consideration paid by each Taxpayer subsidiary for the assets it acquired. Thus, each Taxpayer subsidiary must include the liabilities it assumed in the amount of consideration to be allocated under § 1060. Section 1060 of the Code provides that consideration shall be allocated among the assets acquired in the same manner as amounts are allocated under § 338(b)(5). Section 1.1060-1T(d) prescribes rules for allocating consideration among assets. Section 1.1060-1T(d) generally requires a residual method of allocation.[1]

Under § 197(a), a taxpayer is entitled to an amortization deduction for any amortizable section 197 intangible. The amount of the deduction is determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible ratably over the 15-year period beginning with the month in which the intangible was acquired.

Section 197(c) defines the term "amortizable section 197 intangible" to mean any section 197 intangible -- (A) which is acquired by the taxpayer after the date of enactment of § 197, and (B) which is held in connection with the conduct of a trade or business or an activity described in § 212.

Section 197(d)(1) defines the term "section 197 intangible" to mean (A) goodwill, (B) going concern value, (C) any of the following intangible items: (i) workforce in place including its composition and terms and conditions (contractual or otherwise), (ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers), (iii) any patent, copyright, formula, process, design, patent, knowhow, format, or other similar item, (iv) any customer-based intangible, (v) any supplier-based intangible, and (vi) any other similar item, (D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof, (E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and (F) any franchise, trademark, or trade name.

For purposes of § 197(d)(1)(C)(v), § 197(d)(3) defines the term "supplier-based intangible" to mean any value resulting from future acquisitions of goods or services

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1. Section 1.1060-1T(d) of the temporary regulations was amended on January 9, 1997, to reflect five classes of assets (previously there had been four classes). It appears the Taxpayer is using the allocation method provided in § 1.1060-1T(d) as amended. The Taxpayer is entitled to use the amended version of § 1.1060-1T(d) if § 197 applies to any of the acquired assets and if the Taxpayer and related parties consistently apply the amended regulations to all transactions in which AGUB (as defined in § 1.338(b)-1), MADSP (as defined in § 1.338-(h)(10)-1), or consideration must be allocated under § 338 or § 1060.

pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

Section 197(e)(4)(A) excludes from the definition of a section 197 intangible any interest in a film, sound recording, video tape, book, or similar property unless such intangible is acquired in a transaction involving the acquisition of a trade or business.

The legislative history of § 197 states that the term “section 197 intangible” includes any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. For this purpose, the term “section 197 intangible” is to include package designs, computer software, and any interest in a film, sound recording, video tape, book, or other similar property. The term “section 197 intangible” includes any supplier-based intangible, which is defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a favorable relationship with persons that provide distribution services (for example, favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts, is to be amortized over the 15-year period. H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 675-76 (1993), 1993-3 C.B. 393, 553-54.

The legislative history of § 197 further indicates that the term “section 197 intangible” does not include any interest (including an interest as licensee) in a film, sound recording, video tape, book, or other similar property (including the right to broadcast or transmit a live event) if the interest is not acquired in a transaction (or series of related transactions) that involves the acquisition of assets that constitute a trade or business or a substantial portion of a trade or business. H.R. Conf. Rep. No. 213 at 680, 1993-3 C.B. at 558.

The Taxpayer contends that the Contracts are not interests in a film under § 197(d)(1)(C)(iii) because the subsidiaries did not own the underlying television programming. The Taxpayer’s subsidiaries had no right to sublicense the programming or the ability to exploit other than by broadcasting the programming within specifically defined number, time, and geographic limits. Neither subsidiary could broadcast clips of the programming, and each of them was required to display the owner’s copyright when broadcasting the programs.

Instead, the Taxpayer contends that the Contracts are supplier-based intangibles under § 197(d)(1)(C)(v) and (3). The subsidiaries’ revenues were derived from the sale of advertising time during the television programs which they broadcast. They filled programming schedules by acquiring licenses to broadcast programs. Thus, according to the Taxpayer, the Contracts represented contractual relationships with suppliers of television programming. If the Contracts are treated as supplier-based intangibles, the Taxpayer argues that only the premiums paid for the Contracts in connection with the acquisition of the Stations constitute amortizable section 197 intangibles.

Under § 197(d)(1)(C)(iii), any interest in a film (including an interest as a licensee) is an amortizable section 197 intangible if acquired as part of the acquisition of a trade or business. In the present case, the Taxpayer's subsidiaries acquired the Contracts as part of the acquisition of television station businesses. Consequently, the fair market value of the amortizable section 197 intangibles is the fair market value paid by the subsidiaries for the Contracts plus the amount of any associated assumed liabilities. Moreover, each Contract is a separate section 197 intangible and may not be netted for purposes of § 197.

CAVEAT:

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

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