DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT: Losses on Individual Subscribers and Employees

This Field Service Advice responds to your memorandum, dated May 10, 1999. 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:

Corp X, et al. =
M =
Insurance A =
Entity A =

ISSUE

Whether petitioners properly claimed losses under I.R.C. § 165 with regard to their subscriber-based intangible and assembled workforce.

CONCLUSION

Petitioners may not deduct losses under section 165 with regard to either their subscriber-based intangible or assembled workforce. Both intangible assets are subject to mass asset treatment and the yearly loss of individual subscribers and workforce is not allowable. In addition, petitioners are attempting to change their method of accounting without permission.

FACTS

Corp X. et. al., otherwise referred to as the petitioners is an M entity. Petitioners are in the business of providing Insurance A. For the first time in their petition, petitioners assert that they should be allowed section 165 loss deductions for abandonment of certain intangibles, namely, subscriber accounts and employees.

Subscriber Accounts

Petitioners claim losses for the abandonment of certain subscriber relationships with "underwritten group subscribers" which were in existence on January 1, 1987, but which were subsequently canceled. Underwritten group subscribers are groups for whom petitioners provide insurance coverage that is individually rated based on a particular group's experience. Premiums for the group are based on the anticipated loss experience of that group. Petitioners assert that there were five different categories of subscriber contracts, but that they are only claiming losses on one category, *i.e.*, in the underwritten group category.

We assume, as with other M entities, the actual contract ends yearly and is then renewed. As to method and timing of the abandonment, according to petitioners, there are two primary ways a cancellation occurs: 1) "subscribers can either provide written notice of their intention not to renew their contracts," or 2) "contracts can be canceled due to failure to pay." Occasionally, petitioners would end a relationship if the subscriber fell below certain minimum requirements which were part of the contract. For example, if the subscriber was required to have a certain number of employees and the subscriber fell below that minimum, the contract might be ended.

To determine the timing and the amount of losses from the abandonment of subscriber relationships for 1987 through 1995, petitioners' expert Entity A compared the subscribers whose relationship were canceled (as listed on certain internal management reports) with the list of subscribers as of January 1, 1987. If the subscriber had been in existence on January 1, 1987, a loss was claimed for the abandonment of the subscriber when the subscriber did not renew or did not pay. The value of the abandoned subscriber relationships as of January 1, 1987 was determined by petitioners' expert.

Petitioners claim to have made some attempt to salvage subscriber relationships that were canceled and abandoned due to failure to pay.

Employees

Petitioners claim that during the years 1987 through 1995, they suffered losses "upon the abandonment of employees who were in place on January 1, 1987 and who subsequently terminated employment with [petitioners]." Petitioners' theory is that:

> Experienced . . . employees possess expertise and knowledge specific to the company and are important in sustaining the profitability and

> continued growth of [petitioners]. In the insurance industry, experienced employees, including executives, underwriters, salesmen, and back office support professionals, are valuable assets. The employees in place are valuable because it is costly to locate, screen, hire and train new employees to replace them, as evidenced by the expenditures relating to retaining employees and reducing turnover. Additionally, the more specialized the employee, the greater the cost to acquire them and the greater their value to [petitioners].

Petitioners assert that they are only claiming abandonment losses on employees hired prior to January 1, 1987.

The evidence thus fair shows no employment contracts which might be owned by the employer and which might be bought, sold, traded, or abandoned. In other words, all the employees involved appear to be ordinary employees, who are not under contract.

To determine the timing of the abandonment of employees, petitioners used the Annual Termination List Report printed at the close of the last pay period of each year beginning with 1987. The list includes all employees processed as terminated during the 26 pay periods that closed during the preceding calendar year. Petitioners claim to have experienced their losses during the pay period when an employee was processed as terminated.

Petitioners state that no attempts were made to salvage abandoned employees. To determine the value of the abandoned employees, petitioners looked at each employee and determined the appropriate category (executive, middle management, clerical or staff) for that employee. A loss amount was determined for each employee based on the acquisition cost per employee in the appropriate category as set forth in the expert witness report of Entity A.

<u>LAW AND ANALYSIS</u>:

Background

Petitioners were formerly tax exempt entities under section 501(c)(3), as were other Blue Cross Blue Shield entities. In 1986, Congress ended the tax exemption for Blue Cross Blue Shield entities for years starting after December 31, 1986 in the Tax Reform Act of 1986 (the Act).

Section 1012(a) of the Act revoked the tax-exempt status of certain medical insurers and made the entities taxable under I.R.C. § 833 as if they were stock insurance companies.
Under section 1012(c)(3)(A)(ii) of the Act, the entities receive an adjusted basis in their assets equal to their fair market value as of January 1, 1987, for purposes of determining gain or loss.

The legislative history of section 1012(c)(3)(A)(ii) of the Act states that the fair market value basis adjustment is provided solely for the purpose of determining gain or loss on the sale or exchange of assets and not for depreciation or other purposes. The Conference Report 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. 2 H.R. Conf. Rept. 841, 99th Cong., 2d Sess. II-350 (1986); see also Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. 591 (1987).

Section 165 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 first issue is whether any abandonment loss can be claimed on property valued at fair market under section 1012 of the Act given that the legislative history arguably limits the basis adjustment to the "sale or exchange" of assets. That is, an abandonment is not a sale or exchange. See Citron v. Commissioner, 97 T.C. 200, 213-14 (1991); Equity Planning Corp. v. Commissioner, T.C. Memo. 1983-57. It is the position of the Office of Chief Counsel that the basis provided under section 1012(c) of the Act should be used for computing losses, including abandonment losses, under section 165 incurred by taxpayers subject to section 1012(a) of the Act. Although it may not be cited as precedent, this position is embodied in LTR 9533003.

The requirements for an abandonment 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 the 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 central 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 cases 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)(customer list); 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); Tomlinson v. Commissioner, 58 T.C. 570 (1972), aff'd, 507 F.2d 723 (9th Cir. 1974) (insurance expirations);Hodges v. Commissioner, 50 T.C. 428 (1968), acq. on another issue, 1969-2 C.B. xxiv; Boe v. Commissioner, 35 T.C. 720 (1961), 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); 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 the cases cited directly have held that the loss of an individual component of the indivisible asset could not be separately deducted as a loss. In particular, taxpayers could not deduct amounts attributable to each customer they lost. Fullerton, supra; Sunset Fuel, supra; Golden State Towel, supra; Tomlinson; supra; Hodges, supra; Thrifticheck, 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;" the customer lists were instead treated as “unitary structures irrespective of incidental fluctuations or alterations.” Metropolitan Laundry, 100 F. Supp. at 805. The court noted, however, 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 costs attributable to 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). We note that a workforce intangible would be subject to the rationale of Massey-Ferguson.

Petitioners in the present case have not abandoned a segment of their business that is in any way analogous to the facts of either Metropolitan Laundry or Massey-Ferguson. The distinction between the facts similar to the present case and those found in Metropolitan Laundry has been explicitly recognized by the courts. As stated in Golden State Towel, 373 F.2d at 940-41,

> One cannot say that the plaintiff’s annual crop of terminated customers had a “distinct transferable value” as did the entire body of San Francisco routes in the Metropolitan Laundry instance, for whereas the one might well have constituted the subject matter for a sale had Metropolitan so wished, it cannot be imagined that the plaintiffs would have been able or desirous of selling to another their right to serve the periodically departing customers. There was no market for a piecemeal sale of customers.

See Skilken, 420 F.2d at 270 (no cessation of business in a geographic area of independent significance); Anchor Cleaning, 22 T.C. at 1033-35 (no abandonment or disposition of any identifiable segment of its business).

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 a loss under section 165(a) 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), aff’d in an unpublished opinion, 99-1 USTC ¶ 50,s127 (4th Cir. 1999). 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.

Based upon the above, we conclude that petitioners may not take a deduction under section 165(a) for the loss of individual subscribers or employees lost.

Change in Accounting Method

We believe petitioners have made an unauthorized change in accounting method because petitioners initially filed federal income tax returns treating the intangible assets at issue as single mass assets. Petitioners must obtain permission to change a method from the Secretary. I.R.C. § 446(e).

The description of what constitutes a method of accounting is found under Treas. Reg. § 1.446-1(e). Initially, there is no question a consistent but erroneous treatment of a material item constitutes a method of accounting. Treas. Reg. § 1.446-1(e)(2)(i). See also Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500, 512 (1989), and the cases cited therein.

In addition, under Treas. Reg. § 1.446-1(e)(2)(ii)(a), a change in method of accounting includes not only a change in the overall plan of accounting, but the treatment of any material item used in the overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item involving the proper time for the inclusion of the item in income or the taking of a deduction. See Hamilton Industries v. Commissioner, 97 T.C. 120, 126 (1991). See also Knight-Ridder Newspapers v. United States, 743 F.2d 781, 798 (11th Cir. 1984).

Service position on the requirements for consistent application of a method is found in Rev. Proc. 90-38, 1990-1 C.B. 57. See Sec. 2.01(2) of Rev. Proc. 97-27, 1997-21 I.R.B. at 11. If a taxpayer treats an item improperly in the first return that reflects the item, the taxpayer must treat the item consistently in two or more taxable years before it has adopted a method. Rev. Rul. 90-38, 1990-1 C.B. at 58. If the treatment is proper, such consistency is not required. Thus, the Supreme Court has held that once a permissible election of a method of accounting has been made, it may not be changed after the time for filing the return has passed. Pacific National Co. v. Welch, 304 U.S. 191 (1938).

We believe the treatment of the assets in the present case is analogous to electing to group assets into general asset accounts under section 168(i)(4) for the purposes of depreciating them as a single asset. Rev. Proc. 97-30, 1997-1 C.B. 702, held that the grouping of assets under section 168(i)(4) was a method of accounting. Whether or not petitioners' proposed treatment is deemed correct, they may not employ the new method of accounting without obtaining consent.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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CLIFFFORD M. HARBOURT
Senior Technician Reviewer
Income Tax and Accounting Branch