

Tax Update: Research Deductions in Spin Offs and Other Drop-Downs of Business Divisions --Section 59(e) and PLR 200812005 and 201033014

By Francesco Ferrante, Thompson Hine LLP

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What happens to a corporate division's *unamortized research costs* for federal income tax purposes when the division is separated (in a tax free manner) from the corporation? Which corporation receives the tax benefit following the transfer - the transferee or does it remain with the transferor - and, if the transferee corporation receives the unamortized research cost, what is the tax treatment to the transferee? Given the billions of research dollars invested by multinational corporations, the dollar amounts at stake with respect to this question is significant.

A 2008 letter ruling (200812005) and now a 2010 letter ruling (201033014) answer this basic question that had not been addressed previously by applying a step-into-the-shoes approach. That is, the transferee corporation continues to amortize the research costs in the same manner as the transferor corporation.

This issue can arise in (1) spin-off transactions that involve the transfer of an operating division into separate independent corporations; (2) the mere drop-down of an operating division within a consolidated return and (3) potentially, on the consolidation of a subsidiary corporation into a parent corporation and the merger of two unrelated corporations.

Why would a corporation have an unamortized research cost in the first place? For federal income tax purposes, qualifying research costs can be deducted (a) immediately, (b) amortized over a period of up to five years or (c) amortized over a 10-year period. One reason for selecting 10-year amortization for research expenses is to allow the corporation's annual income to remain high and use other tax attributes to reduce such income. For example, if a corporation has foreign tax credits that would otherwise expire, a corporation might want to maximize income so that such credits can be used prior to their expiration. If, instead, the corporation claimed an immediate deduction for the research costs, the annual income available to absorb the foreign tax credits would be reduced, with the possibility that the credit might expire before being fully absorbed. Note that this issue does not surface to the extent that the taxpayer claims a research credit with respect to the research expenses. The relevant provisions of the Internal Revenue Code that permit these alternative approaches are Sections 174(a), 174(b) and 59(e). The five-year Section 174(b) and the ten-year Section 59(e) provisions differ in their application.

The rulings concludes that the unamortized account relating to the transferred business carries over to the transferee corporation and the transferee corporation steps into the shoes of the transferor corporation and continues the same amortization method as started by the transferor corporation. This is a simple and easy rule to administer but, in a spin-off transaction, it results in a loss of a tax attribute to the corporation that incurred the expense.

Example: Corporation A, which has many operating divisions, incurred \$100 million in qualifying research expenses during 2005 with respect to Division #1 which it elected to amortize over 10 years (\$10 million per year) pursuant to a Section 59(e) election. On December 31, 2009, Corporation A transfers Division #1 to its wholly owned subsidiary, Corporation B, in

connection with a spin-off of the Corporation B shares. The IRS response is that the \$50 million in unamortized research expenses as of January 1, 2010 carries over to Corporation B and such amount can be amortized-- \$10 million annually-- during 2010-2014 (i.e., the remaining 5 years of the initial 10-year amortization period).

In reaching this conclusion, the IRS rejected a number of alternative positions. One alternative position is that the unamortized amount remains with the corporation that incurred the expense. A second alternative position is that, even if the unamortized amount carries over to the transferee corporation, the transferee corporation does not continue the same amortization period as the transferor. If the transferee corporation does not step into the shoes of the transferor corporation there would be various potential approaches regarding the treatment of the unamortized amount by the transferee. These approaches include (i) waiting until the transferred business is ultimately sold by the transferee corporation at which time the unamortized amount can be used in the calculation of gain or loss; (ii) undertaking a study to determine the useful life of any technology developed and, if determined, the unamortized amount can be deducted over such useful life; (iii) determining if a safe harbor useful life is available over which the transferee corporation can amortize the carryover balance; (iv) considering whether to divide the unamortized amount among each independent technology component to which the research costs relate and have the transferee corporation claim a deduction as each such component becomes obsolete or (v) considering whether the unamortized amount can be added to the costs of goods sold for the opening inventory of the transferee corporation. Most of these alternatives would involve effort and cost with the potential for future factual disputes with the IRS. However, some of these approaches could have allowed the transferee corporation to claim a deduction faster than might be available under a step-into-the-shoes approach.

The discussion above focuses on transfers between corporations. A similar analysis applies when either (i) a corporate division is transferred to a partnership or (ii) the research expense is incurred by an individual or single member LLC and such business operation is transferred to a corporation or partnership. The facts of the letter ruling involve a divisive spin-off restructuring. In certain other transactions, a specific tax provision (Section 381 of the Internal Revenue Code) could be applicable to reach a similar result if the corporate reorganization fits within specific reorganization tax provisions.

The ruling assists the FIN 48 process of determining the appropriate tax position to take with respect to future deductions available to the transferee corporation and whether the transferor corporation has to also reflect an adjustment for financial accounting purposes. While private letter rulings are directed only to the taxpayers who request them, the conclusion in this recent ruling can be supported by a solid level of analysis. A second ruling confirms that the IRS continues to accept this approach.

Francesco A. Ferrante
Thompson Hine LLP
(937)443-6740 – Telephone
(937)470-0598 – Cell
(937)443-6635 – Fax
Francesco.Ferrante@ThompsonHine.com