Office of Chief Counsel
Internal Revenue Service

memorandum

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RMBoulanger

date: MAY 26 1999

to: Jozef Chilinski, Team Coordinator, E:1107
Thru: John Camp, CEP Case Manager

from: District Counsel, Buffalo

subject: [redacted] -
Technology Claim

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DISCUSSION

This memorandum is in response to your request for advice concerning the above-referenced matter. Specifically, you have asked us to review [redacted]'s (taxpayer) claim made subsequent to the issuance of the Form 5701 concerning the amortization of certain "technology". It is our position that the taxpayer is not entitled to amortize what the taxpayer has classified as "technology" acquired pursuant to a transaction the taxpayer has nominated a "contingent purchase transaction".

The initial [redacted] division of the [redacted] operating subdivision between the taxpayer and [redacted] was along geographic lines and was treated as a tax free I.R.C. § 355 division "split-off". There was no "acquisition" of technology by the taxpayer in [redacted], [redacted] or otherwise.

FACTS

[redacted] is a U.S. holding company incorporated in [redacted] and prior to [redacted] was owned equally by the unrelated foreign stockholders: [redacted] a [redacted] company ([redacted], [redacted], a [redacted] company ([redacted], and [redacted] a [redacted] company, ([redacted]), and their subsidiaries.

The principal operating subsidiaries of [redacted] were a U.S. company, [redacted], a [redacted] company, [redacted] ([redacted]), a [redacted] company, [redacted], and a [redacted] company, [redacted] Except for a [redacted]% ownership in [redacted], held by related minority investors, the stock of [redacted] and each of the operating subsidiaries was originally owned directly or indirectly, [redacted] by [redacted] [redacted] and [redacted] for more than [redacted] years.

[redacted] and [redacted] entered into a "Framework Agreement" (FA) dated [redacted] This provided the basic cooperation agreement among stockholders as to the sale of stock by [redacted] division of business operations along the geographic lines between [redacted] and [redacted] and cooperative management of so-called "[redacted] technology". The details related to the sale of stock by [redacted] are incorporated in the "Share Purchase Agreement" (SPA) dated [redacted]. Details related to the division of business between [redacted] and [redacted] are Incorporated in the Stock Purchase and Exchange Agreement (SPEA) dated [redacted].

The FA also anticipated formation of a separate company to be owned [redacted] by [redacted] and [redacted]. This proposed entity would manage the existing technology and develop and license new technology. With respect to the use of technology, the FA states in part as follows:

[redacted]

See FA, pg. [redacted].

By [redacted], [redacted] and its affiliates and [redacted] and its affiliates had encountered substantial disagreement with respect to the interpretation of the [redacted] agreements. As a result, the provisions of the FA were never fully implemented. The proposed joint venture technology company was not formed. No royalties beyond the phase-out of royalty obligations to [redacted] for old orders at the reduced rate were ever paid. Any existing accruals were reversed.

As a result, [redacted] and its affiliates filed suit in [redacted] to prevent [redacted] from using the [redacted] technology. After several years of litigation, a lower court issued a decision in favor of [redacted]. The lower court's decision was appealed by [redacted] [redacted] and [redacted] entered into the [redacted] Settlement Agreement before an appeals court heard the case.

The Settlement Agreement provided that [redacted] would make an additional payment of $[redacted] in cash to [redacted] in settlement of all claims of [redacted] and its affiliates against [redacted] and its affiliates. The Settlement Agreement also provided that [redacted] and its affiliates would have royalty-free rights to use [redacted] patents owned by [redacted] in the geographic territory of the United States of America, [redacted], [redacted] and [redacted]. [redacted] also has the rights to designing, engineering, and development of products covered by [redacted] patents, on a worldwide basis.

[redacted] and its affiliates would have royalty-free rights to use [redacted] patents owned by [redacted] in the geographical areas outside the United States of America, [redacted], [redacted] and [redacted]. They would also have the rights to make products, covered by [redacted] patents, on a worldwide basis.

In addition, [redacted] and its affiliates would own the "[redacted]" trademark in the United States of America, [redacted], [redacted] and [redacted]. [redacted] and its affiliates would own the "[redacted]" trademark in the rest of the world.

As already discussed above, but more specifically, on [redacted], pursuant to a Share Purchase Agreement (SPA), [redacted] was acquired by the remaining [redacted] shareholders. [redacted] then became [redacted] owned by [redacted] and [redacted]. [redacted] and [redacted] then agreed to divide their joint holdings according to a Stock Purchase and Exchange Agreement (SPEA) dated [redacted].

Under the terms of SPEA, [redacted] sold its interest in [redacted], and [redacted] to [redacted], [redacted] exchanged its interest in [redacted] [redacted] and [redacted] for [redacted] shares of its own common stock. [redacted] (taxpayer), a U.S. holding company of [redacted], purchased [redacted] shares of [redacted] stock

and [redacted] shares of [redacted] stock from [redacted]. As a result of the division, [redacted] owned [redacted] and [redacted] and [redacted] owned [redacted] [redacted] and [redacted] subsidiaries.

The exchange of [redacted] [redacted] and [redacted] stock by [redacted] for its own stock was reported on the [redacted] Federal Income Tax Return as a tax free "split-off" under I.R.C. § 355. In addition, [redacted] shares of [redacted] and [redacted] shares of [redacted] (representing [redacted]% of its investment were sold on [redacted] for cash to [redacted] and [redacted] and the sale reported on Schedule D.

Through [redacted], [redacted] accrued and paid a [redacted]% fee, [redacted]% for royalties and [redacted]% for research and development royalty to [redacted]. In [redacted], [redacted] accrued royalties at [redacted]% to [redacted] only for prior orders. For a short time, royalties were also accrued but reversed as a result of the dispute between [redacted] and [redacted]. As part of the [redacted] settlement, [redacted] also paid $[redacted] in [redacted] for all royalties due to [redacted].

It is important to note that the issue concerning the purported "acquisition" and "amortization" of the [redacted] "technology" was presented by the taxpayer to examination as a claim. This was subsequent to Examination's issuance of the Form 5701.

DISCUSSION

The taxpayer's position is essentially the following: Because of a lawsuit settlement and the payment by the taxpayer of $[redacted] in [redacted], it is entitled to amortize a cost basis of $[redacted] beginning in [redacted] The amortization is being claimed, starting in [redacted] on the theory that the [redacted] settlement represents the closing of a "contingent purchase transaction" initiated in [redacted]. The $[redacted] cost basis allocated to the technology in [redacted] consists of deemed annual royalty payments capitalized since [redacted]. The taxpayer proposes that these would be amortized on a straight line over [redacted] years ([redacted] - [redacted]). The $[redacted] actually paid in [redacted] would be amortized on a straight line over [redacted] years ([redacted] - [redacted]).

The taxpayer's arguments supporting its claim are apparently contained in an [redacted] memorandum from [redacted] which is stamped "Draft". The Service has requested the actual, non-draft, memorandum in a [redacted] IDR. They have refused to provide it. However, a cover letter attached to the "Draft" states that although the memorandum may be subject to change, "we anticipate that any changes to the memo would be minor."

The taxpayer presents three (3) arguments in its [redacted] draft memorandum ("Memo"). For the sake of simplicity, we will analyze each argument in the order presented by the taxpayer.

Argument 1: Contingent Purchase Transaction

The taxpayer's first argument is that the "acquisition" of the right to use [redacted] technology should be "[redacted]. As such, the "[redacted]" (Id. emphasis added)

Specifically, it appears that the taxpayer is arguing that there was a stock purchase and technology purchase (i.e. two components) in [redacted], with the technology aspect of the sale being "closed" in [redacted].

However, we have reviewed the numerous documents you have submitted. It is our opinion that the documents thus far submitted by the taxpayer not only fail to substantiate their argument, but are, for the most part contradictory to their claim that this was a so-called "contingent purchase transaction".

Because of the number of documents you have forwarded, for the purpose of this memorandum, we will discuss only a select few. However, these documents are by way of representation not limitation.

A. [redacted] Memorandum

In a memorandum dated [redacted], the taxpayer set forth an overview of the [redacted] [redacted] restructuring. The following is essentially a verbatim recitation of the facts as set forth in that memorandum.

In [redacted], the [redacted] parent companies decided to restructure their interests in [redacted] for non-tax reasons. The business deal involved three basic steps:

> 1. [redacted] and [redacted] bought for cash in [redacted] shares the [redacted] stock interest in the [redacted] companies owned by [redacted]. As a result of this purchase which took place in [redacted], the [redacted] Companies (exclusive of the minority interest in [redacted]) became [redacted] owned by [redacted] and [redacted].

2. [redacted] and [redacted] agreed to divide the [redacted] companies up into two geographic groups, a North American group to be wholly-owned by [redacted] and a non-North American group to be wholly-owned by [redacted] (the "Division"). [redacted] and [redacted] agreed to jointly develop technology and not to compete following the Division in the [redacted] technology and business field in each other's territory. The purpose of the Division was to allow each of [redacted] and [redacted] to pursue the business of the [redacted] companies on its own in its respective territory. This was intended to enhance the overall efficiency and profitability of the [redacted] businesses. In the United States, the Division allowed [redacted] to offer a more complete line of products for the [redacted] industry. The Division took place on [redacted].

3. Following the division, [redacted] and [redacted] had agreed to cooperate in various way (even though they were no longer sharing profits and losses from the [redacted] business earned within their regions). Especially, it was expected that they would engage in joint research and development work.

With respect to the steps involved in effecting the division, these are set out in the SPEA. The basic mechanics were quite simple. The transaction was a tax-free "split-off" by [redacted] of stock which it owned in the Foreign Companies. Specifically, [redacted] distributed all of the stock it owned in the Foreign Companies to [redacted] in exchange for stock of equal value which [redacted] owned in [redacted] (which was less than all the [redacted] stock owned by [redacted]). [redacted] did not own any "securities" of the Foreign Companies. [redacted] then sold to [redacted] for cash all but a nominal amount of the stock which [redacted] owned in [redacted] and the remaining stock it held in [redacted]. Immediately after the Division, [redacted] remained as a holding company, with substantially all of its assets consisting of [redacted] stock. These steps are described in more detail (with specific numbers) below. In connection with the Division, there were no contributions of distributions of assets between [redacted] and the Operating Companies.

Based upon the facts above, which are directly from the taxpayer's [redacted] memorandum, the taxpayer is not entitled to an allocation of $[redacted] as a cost basis to the [redacted] technology. The [redacted] SPA relates to the acquisition of the corporate stock of [redacted] by [redacted] and [redacted].

There is no mention of contractual contingencies or purchase of technology by the taxpayer.

Further, this buyout was not and could not be treated as a deemed I.R.C. § 338 transaction since no election was made nor gain reported by the target companies [redacted] and [redacted].

The [redacted] division of the operating subsidiaries between [redacted] and [redacted] was along geographic lines and treated as a tax-free I.R.C. § 355 "split-off". It was a divisive reorganization, not an acquisitive transaction. (i.e., I.R.C. § 338).

B. Framework Agreement

In the [redacted] draft memorandum, the taxpayer continually refers to the "Framework Agreement" ("FA") dated [redacted] to support its contention that this was a so-called "contingent purchase transaction."

However, beside the general overriding tone of the FA supporting our analysis that this was a division of [redacted] holdings along territorial lines and a sharing of the technology without compensation, we have provided below a number of provisions taken directly from the FA that contradict the taxpayer's current arguments and support Examination's position:

- [redacted] and [redacted] aim to . . . control the technology of the [redacted] group in mutual cooperation between [redacted] and [redacted] (Pg. [redacted] transmittal copy of FA provided to Service on [redacted], pursuant to IDR request dated [redacted]).

- [redacted] and [redacted] aim to . . . divide geographically the companies and the operations of the [redacted] group between [redacted] and [redacted]. Id. at pg. [redacted].

- The parties strive to develop the cooperation between [redacted] and its owners concerning research and development as well as separate projects in such a way that the products of [redacted] and those of the owners support each other by way of joint subdeliveries or by way of other cooperation arrangements. Id. at pg. [redacted]

- As part of the division of the operations of the [redacted] group between [redacted] and [redacted] [redacted] and [redacted] and their respective [redacted] companies as well as possible successors agree not to compete with one another within the technology and business fields of Kamyr. Id. at pg. [redacted]

- Both the [redacted]-group and the [redacted]-group shall have equal rights to utilize within its geographical territory all existing products and all existing technology

developed and/or owned by the [redacted] companies, e.g., through cross licensing of existing patents and through exchange of existing technical information. Herewith the license fees from [redacted] to [redacted] will be discontinued. Id. at pg. [redacted].

● The parties agree on the division of the values of respective [redacted] groupings as follows:

. . . The value for the North American part is [redacted] and that for the rest of the world [redacted] of the total value of [redacted], excluding the part owned by the minority shareholders of [redacted]. The parties will pay the tax caused to [redacted] Group by this restructuring in the same proportion. The parties will make a joint attempt to accomplish the lowest tax possible.

This is based on the condition that the transfer of equal rights to the technology from [redacted] to [redacted] takes place without compensation from [redacted] or [redacted] (emphasis added) Id. at pg. [redacted].

Based upon the FA, there is no reference or discussion of any deemed annual royalty payments or license fees. The message of the FA is clearly that the technology at issue was to be shared equally by the taxpayer and [redacted] along geographic lines, without compensation.

C. Signing Memorandum

Further, in a "Signing Memorandum" dated [redacted] the taxpayer stated and agreed as follows:

[redacted]

[redacted]

This memorandum merely sets out what we have already discussed above, that these documents represent an agreement to share [redacted] technology equally along geographic lines without compensation.

D. Pleadings

The taxpayer, as set forth above, was involved in extensive litigation with [redacted] and other parties regarding any number of issues. The revenue agent has supplied a portion of the pleadings for our review. Although the pleadings forwarded for our review are lengthy, they no doubt represent a very small amount of what was passed between the parties. However, certain factual assertions and allegations by the taxpayer in various of the documents are supportive of Examination's position.

In the taxpayer's Answer And Counterclaims And Third-Party Complaint dated [redacted], paragraph [redacted] the taxpayer alleges:

[redacted]

The Answer at paragraph [redacted] alleges:

[redacted]

[redacted]

Again, the pleadings do not support the taxpayer's assertions.

E. Settlement Agreement and Mutual Release

On or about [redacted] the taxpayer, [redacted] and their affiliates entered into a Settlement Agreement with respect to the aforementioned litigation. Among other things, the taxpayer was required to pay [redacted] approximately $[redacted] in order to settle the case.

The taxpayer alleges that this $[redacted] payment was for the "acquisition of the . . . intangible asset-a royalty free license to use the technology (hereinafter referred to as the right to use the technology')". Memo page [redacted]

Further, the taxpayer states that the "subsequent $[redacted] payment for the right to use the technology was made during [redacted] in accordance with the Settlement Agreement." Id. at page [redacted].

However, a review of the actual Settlement Agreement ("SA") indicates that "the purpose of [the] Agreement is to clarify and confirm the existing rights of the parties with respect to certain technology". (emphasis added) SA at page [redacted] The fact is, the taxpayer did not pay $[redacted] for a royalty free license. This was in settlement of the lawsuit filed by [redacted] against the taxpayer on various grounds.

Argument 2: Allocation of Purchase Price Between Stock and Technology

The taxpayer argues that the acquisition of the right to use the [redacted] technology by [redacted] and its affiliates is somehow an acquisition of a separate and distinct asset, and that a "purchase price" should be allocated to the stock and the right to use the technology based on their reconstructed fair market values.

As set forth above, it is our opinion that the taxpayer has failed to demonstrate that there was in fact any acquisition of the technology by the taxpayer.

The documents clearly demonstrate that what did take place was an I.R.C. § 355 "split-off" with the aim of geographically dividing the [redacted] operations between the taxpayer and [redacted].

In fact, page [redacted] of the FA clearly states that:

[redacted]

Therefore, the taxpayer's second argument regarding allocation of the purchase price is without merit since the documents they have provided clearly demonstrate there was no acquisition of technology in [redacted], [redacted] or otherwise.

Argument 3: Amortization of Technology

The final argument the taxpayer makes in their [redacted] draft memorandum is how the so-called "purchase price" of the technology should be amortized. The taxpayer's discussion of this issue begins as follows.

[redacted]

Memo at page [redacted].

The memo then goes on to a general discussion of amortization based upon a cost basis in the asset received in a "taxable purchase".

The fact is, there was no "taxable purchase" of any technology by the taxpayer in [redacted] [redacted] or any other year. In fact, on page [redacted] of the memo, the taxpayer states that its "methodology" for determining the amortization is based upon I.R.C. § 338.

It is unclear whether the taxpayer is arguing that this transaction in [redacted] was somehow a "deemed" I.R.C. § 338 acquisition or that they are merely using the methodology contained therein. In any event,

(a) there is no concept that recognizes a "deemed" I.R.C. § 338 transaction;

(b) the methodology described in Treas. Reg. § 1.338(b)-3T addresses acquisitive transactions. This was a divisive I.R.C. § 355 "split-off"

(c) there was no acquisition of technology in [redacted], [redacted] or otherwise.

CONCLUSION

In the situation presented, it is our position that [redacted] and its affiliates (in part the taxpayer) did not make an acquisition of [redacted] technology in [redacted], [redacted] or otherwise. Therefore, the taxpayer's claim to amortize these alleged capitalized royalty payments from [redacted] totalling $[redacted] are without merit.

With respect to the $[redacted] payment made in [redacted] to settle outstanding litigation, the right to amortize is being claimed by [redacted]. However, it appears that [redacted] ([redacted] actually paid the amount at issue.

The taxpayer was sent an IDR dated [redacted] requesting the following information:

> Please show the accounting treatment for book purpose by [redacted] and [redacted] of the [redacted] legal settlement reached in [redacted] with [redacted]. In addition:
>
> A. Please show who paid the settlement amount.
>
> B. Please provide the proof that the technology obtained under the [redacted] settlement was transferred by [redacted] to [redacted].
>
> C. Was any charge made by [redacted] to [redacted] or any other subsidiaries to recover the cost of the [redacted] settlement?

It is our understanding that the taxpayer failed to respond to such inquiries in a manner that would substantiate the alleged payment.

Therefore, it is our position at this time, that the taxpayer's claim should be rejected in total.

If you have any questions regarding the above, please contact Ray Boulanger of this office at 551-5610.

EDWARD D. FICKESS
Assistant District Counsel