INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 21, 1999

Number: **200016004**
Release Date: 4/21/2000
Index (UIL) No.: 41.55-09
CASE MIS No.: TAM-114425-99/CC:DOM:P&SI:B7

District Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer:

Distributing:

Date 1:

ISSUE(S):

In a transaction that purportedly qualified as a divisive spin-off under §§ 355 and 368(a)(1)(D) of the Internal Revenue Code, did Taxpayer acquire a major portion or a separate unit of Distributing for purposes of applying § 41(f)(3)(A)?

CONCLUSION:

Taxpayer acquired a major portion or a separate unit of Distributing for purposes of applying § 41(f)(3)(A).

FACTS:

On Date 1, Distributing transferred part of its assets to Taxpayer in an exchange

that purportedly qualified as divisive spin-off under §§ 355 and 368(a)(1)(D). Taxpayer concedes that the assets transferred to Taxpayer constituted a transfer of a major portion of a separate unit of Distributing's trade or business. Before Date 1, Distributing paid or incurred qualified research expenses within the meaning of § 41(b) attributable to the major portion of the separate unit of Distributing that was transferred to Taxpayer on Date 1.

LAW AND ANALYSIS:

Section 41 provides a credit against tax for increasing research activities (the research credit).[1] Generally, the research credit is equal to the sum of (1) 20 percent of the excess of the taxpayer's qualified research expenses over its base amount, and (2) 20 percent of the taxpayer's basic research payments determined under § 41(e)(1)(A).

Section 41(c) describes the computation of the base amount. For tax years beginning after December 31, 1989, the base amount is computed by multiplying the taxpayer's fixed-base percentage by its average annual gross receipts for the preceding four years.[2] In general, a taxpayer's fixed-base percentage is the ratio that its aggregate qualified research expenses for the 1984 through 1988 period bears to its aggregate gross receipts for the period.

Section 41(c)(3)(B) provides special rules for determining the fixed-base percentage for start-up companies. Under § 41(c)(3)(B)(i), for taxable years beginning after December 31, 1989, if there are fewer than three taxable years beginning after December 31, 1983 and before January 1, 1989, in which the taxpayer had both gross receipts and qualified research expenses, the taxpayer is a start-up company for purposes of determining the fixed-base percentage. Further, for taxable years beginning after June 30, 1996, if the first taxable year in which a taxpayer had both gross receipts and qualified research expenses begins after December 31, 1983, the taxpayer is a start-up company for purposes of determining the fixed-base percentage.

Under the special rule contained in § 41(c)(3)(B), a start-up company is assigned a fixed-base percentage of three percent for each of its first five taxable years after

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[1]The research credit provisions were initially enacted by section 221 of the Economic Recovery Tax Act of 1981 (the 1981 Act), 1981-2 C.B. 256, 293, as section 44F of the Code. Section 44F was redesignated as section 30 by section 471(c)(1) of the Deficit Reduction Act of 1984, 1984-3 (Vol. 1) C.B. 2, 334. Section 30 of the Code was redesignated as section 41 by section 231(d)(2) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 2, 95.

[2]Under § 41(c)(2), however, the minimum base amount is 50 percent of the credit year qualified research expenses.

1993 in which it incurs qualified research expenses. A start-up company's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses will be a phased-in ratio based on the start-up company's actual research experience. For all subsequent taxable years the start-up company's fixed-base percentage will be its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993.

As originally enacted in 1981, the research credit contained rules for computing the research credit where a business changed hands. The legislative history to the Economic Recovery Tax Act of 1981 (the 1981 Act) explained that the rules were intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer. If § 41had not included rules for changes in ownership of a business, a taxpayer who began a business by buying and operating an existing company might be entitled to a credit even if that taxpayer had not increased the amount of qualified research expenditures. Also, the sale of a unit of a business might have caused the seller to lose any research credit even though the seller had increased the qualified research expenditures in the part of the business that the seller had retained. H. Rep. No. 97-201, 1981-3 C.B. (Vol. 2) 364 and Sen. Rep. 97-144, 1981-3 C.B. (Vol. 2) 442.

Congress revised the computation of the research credit in the Revenue Reconciliation Act of 1989 (the 1989 Act). In explaining the 1989 Act revisions to the computation of the research credit, the House Report simply states that the rules relating to the aggregation of related persons and changes in ownership are the same as under present law with the modification that when a business changes hands, qualified research expenses and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage. H. Rep. No. 101-247, reprinted in 1989 U.S.C.C.A.N. 1906, at 2672. Thus, § 41(f)(3)(A), as amended, provides that if a taxpayer acquires the major portion of a trade or business of another person (hereinafter in this paragraph referred to as the "predecessor") or the major portion of a separate unit of a trade or business of a predecessor, then, for purposes of applying § 41 for any taxable year ending after such acquisition, the amount of qualified research expenses paid or incurred by the taxpayer during periods before such acquisition shall be increased by so much of such expenses paid or incurred by the predecessor with respect to the acquired trade or business as is attributable to the portion of such trade or business or separate unit acquired by the taxpayer, and the gross receipts of the taxpayer for such periods shall be increased by so much of the gross receipts of such predecessor with respect to the acquired trade or business as is attributable to such portion.

Further, § 41(f)(3)(B) provides that if a taxpayer disposes of the major portion of any trade or business or the major portion of a separate unit of a trade or business in a

transaction to which § 41(f)(3)(A) applies, and the taxpayer furnished the acquiring person such information as is necessary for the application of § 41(f)(3)(A), then, for purposes of applying § 41 for any taxable year ending after such disposition, the amount of qualified research expenses paid or incurred by the taxpayer during periods before such disposition shall be decreased by so much of such expenses as is attributable to the portion of such trade or business or separate unit disposed of by the taxpayer, and the gross receipts of the taxpayer for such periods shall be decreased by so much of the gross receipts as is attributable to such portion.

Section 1.41-9(b) provides that, for the meaning of “acquisition,” “separate unit,” and “major portion,” see § 1.52-2(b). In addition, § 1.41-9(b) provides that an “acquisition” includes an incorporation or a liquidation. No further clarification or examples describing an acquisition are provided in the regulations under § 41.

Section 1.52-2(b)(1)(i) provides that the term "acquisition" includes certain lease agreements. Further, § 1.52-2(b)(1)(ii) provides that neither the major portion of a trade or business nor the major portion of a separate unit of a trade or business is acquired merely by acquiring physical assets. The acquisition must transfer a viable trade or business.

Under § 1.52-2(b)(2), a separate unit is a segment of a trade or business capable of operating as a self-sustaining enterprise with minor adjustments. The allocation of a portion of the goodwill of a trade or business to one of its segments is a strong indication that the segment is a separate unit. Section 1.52-2(b)(2) provides several examples illustrating the acquisition of a separate unit of a trade or business. Each of these examples assumes that there is an acquisition of assets.

Section 368(a)(1)(D) provides, in part, that the term reorganization means a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer, the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred is distributed in a transaction which qualifies under § 354, 355 or 356.

Section 355(a)(1) provides that if-

> (A) a corporation (referred to in § 355 as the “distributing corporation”) distributes to a shareholder, with respect to its stock or distributes to a security holder in exchange for securities, solely stock or securities of a corporation (referred to in § 355 as the “controlled corporation”) that it controls immediately before the distribution;

(B) the transaction was not used principally as a device for the distribution of earnings and profits of the distributing or the controlled corporation or both;

(C) the requirements of § 355(b) (relating to active businesses) are satisfied; and

(D) as part of the distribution, the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution, or an amount of stock in the controlled corporation constituting control within the meaning of § 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax;

then no gain or loss shall be recognized to such shareholder or security holder on the receipt of such stock or securities.

The issue in this case is whether Taxpayer acquired a major portion of Distributing's trade or business or a major portion of a separate unit of Distributing's trade or business on Date 1. If Taxpayer acquired a major portion of Distributing's trade or business or a major portion of a separate unit of Distributing's trade or business on Date 1, § 41(f)(3) applies. For purposes of applying § 41 for any taxable year ending after Date 1, the amount of qualified research expenses that Taxpayer paid or incurred during periods before such acquisition, including the base years, is increased by the qualified research expenses Distributing paid or incurred with respect to the acquired trade or business as is attributable to the portion of the trade or business, or separate unit Taxpayer acquired, and the gross receipts of Taxpayer for such periods must be increased by so much of the gross receipts of Distributing with respect to the acquired trade or business as is attributable to such portion.

Taxpayer does not dispute that, on Date 1, a major portion of a separate unit of Distributing was transferred to Taxpayer. Instead, Taxpayer argues that Taxpayer did not "acquire" a major portion of a separate unit of Distributing for purposes of applying § 41(f)(3)(A). Taxpayer asserts that, because his transaction was not a transfer of substantially all of the assets of Distributing, but rather, a transfer of part of the assets of Distributing that purportedly qualified under § 368(a)(1)(D) and § 355, the transfer of assets from Distributing to Taxpayer was not an acquisition for purposes of § 41(f)(3). Further, Taxpayer argues that Taxpayer began operations as a new company and Taxpayer should be treated as a start-up company for purposes of determining its fixed-base percentage.

We believe that Taxpayer acquired a viable trade or business from Distributing as a result of the transfer on Date 1. Further, we believe that the transfer on Date 1 is

one type of transaction Congress contemplated when in the 1981 and the 1989 Acts, Congress enacted and revised the rules in § 41(f)(3). Under the rules in § 41(f)(3), qualified research expenses and gross receipts for periods before the change of ownership are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage. Therefore, we conclude that as a result of the transfer on Date 1, Taxpayer acquired a major portion of a separate unit of a trade or business for purposes of applying § 41(f)(3)(A).

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