Internal Revenue Service

Department of the Treasury

Number: **200137014**
Release Date: 9/14/2001
Index Number: 197.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

,

Refer Reply To:
CC:PSI:5–PLR-108050-01
Date:
June 8, 2001

In re:

LEGEND

Taxpayer	=
Country 1	=
Country 2	=
Licensor	=
Year 1	=
Year 2	=
Date 1	=
State	=
a	=
b	=
c	=
d	=
e	=

Dear :

This letter responds to your letter dated February 6, 2001, submitted on behalf of Taxpayer, requesting a letter ruling under §§ 197 and 1253 of the Internal Revenue Code.

Taxpayer represents that the facts are as follows.

FACTS

Taxpayer is a corporation organized and existing under the laws of State. Taxpayer was incorporated in Year 1 . Prior to Year 2, . In Year 2, .

, Taxpayer (including its subsidiaries) is engaged in . Pursuant to licensing agreements dated Date 1, as amended thereafter, Taxpayer uses certain trademarks, trade names, and technology of Licensor and distributes products made by Licensor.

Licensor's technology is .

provides equipment used by Taxpayer in its laboratories. However, the bulk of Taxpayer's equipment is purchased from . .

Taxpayer and Licensor would like to continue their arrangement and expand its scope to give Taxpayer broader access to Licensor's technology and provide better indemnities than provided for in the earlier licensing agreements. Accordingly, Taxpayer will enter into a new licensing agreement (License Agreement) with Licensor.

Under the License Agreement, Licensor will grant Taxpayer the right to manufacture, market, distribute, and sell certain products (Licensed Products) and to use certain technology (Technology) and trademarks (Licensed Trademarks) belonging to Licensor on an exclusive basis in Country 1.

The License Agreement provides that Taxpayer must pay the following royalties to Licensor, which are payable in full in e day intervals: 1) c percent of net sales related to Licensed Products for the right to use the Technology and the technical services; 2) d percent of net sales related to Licensed Products for the right to use the Licensed Trademarks; 3) d percent of net sales related to Accessories (defined as items, articles, and devices bearing the Licensed Trademarks which are neither made in accordance with, nor embody or utilize the Technology and which are sold or used in conjunction with Licensed Products) for the use of the Licensed Trademarks; and 4) to the extent Taxpayer sublicenses the use of the Technology to third parties, b percent of net sales achieved by any such third party sublicensees with products based on the Technology.

In addition, Taxpayer makes the following representations: 1) The entering into of the License Agreement will not be part of a broader transaction that constitutes the acquisition of a trade or business; 2) the Technology or a substantial portion thereof has significant application in the industry beyond the manufacture of the Licensed Products; 3) ; 4) none of the intangibles subject to the License Agreement will be customer-based intangibles; and 5) the Technology has significant application in areas outside of Country 1.

RULING REQUESTED

Taxpayer requests the Service to rule that the payments to be made by Taxpayer to Licensor pursuant to the License Agreement will not be chargeable to capital account under § 197, and will be currently deductible.

LAW AND ANALYSIS

Section 197(a) provides that a taxpayer shall be entitled to an amortization deduction with respect to 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 a 15-year period beginning with the month in which the intangible was acquired.

Section 197(c) generally defines the term “amortizable section 197 intangible” to mean any § 197 intangible that is acquired by the taxpayer after the date of enactment of § 197, and held in connection with the conduct of a trade or business activity described in § 212.

Section 1.197-2(a)(3) of the Income Tax Regulations provides that § 197 does not apply to amounts that are not chargeable to capital account under § 1.197-2(f)(3) (relating to basis determinations for covenants not to compete and certain contracts for the use of § 197 intangibles) and are otherwise currently deductible.

Section 197(d)(1)(F) and § 1.197-2(b)(10)(i) provide that § 197 intangibles include any franchise, trademark, or trade name. Section 197(f)(4) and § 1.197-2(b)(10)(i) also provide that the term “franchise” has the meaning given to such term in § 1253(b)(1), and the renewal of franchise, trademark, or trade name is treated as an acquisition of the franchise, trademark, or trade name. Section 1.197-2(b)(i) further provides that the term “franchise” includes any agreement that provides one of the parties to the agreement with the right to distribute, sell, or provide goods, services, or facilities, within a specified area.

Section 197(f)(4)(C) and § 1.197-2(b)(10)(ii) provide that any amount that is paid or incurred on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name and that is subject to § 1253(d)(1) is not included in the basis of a § 197 intangible.

Section 1.197-2(e)(2)(i) generally provides that the acquisition of a franchise, trademark, or trade name constitutes the acquisition of a trade or business or a substantial portion thereof.

Section 1253(b)(1) provides that the term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area. This definition is provided for purposes of § 1253(a), which provides that a transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

Courts have construed the definition of franchise broadly to include: the right to construct and operate cable television access within a specific geographical area (Tele-Communications, Inc. v. Commissioner, 12 F.3d 1005 (10th Cir. 1993)); the right to sell and distribute a computer program and to provide customizing and related technical support, (Syncsort Inc. v. United States, 31 Ct. Cl. 545 (1994)); as well as more-traditional, McDonald's or Dairy Queen-type franchises. Canterbury v. Commissioner, 99 T.C. 223 (1992)(operation of a McDonald's restaurant). Courts have noted that Congress provided an "expansive definition" of franchise to "include" agreements to sell or distribute goods within a specified area, which does not exclude other things otherwise within the meaning of a franchise. See, e.g., Jefferson-Pilot Corp. v. Commissioner, 98 T.C. 435, 441 (1992), aff'd, 995 F.2d 530 (4th Cir. 1993).

In the instant case, the License Agreement gives Taxpayer the right to manufacture, market, distribute, and sell products under Licensor trademarks and trade names using Licensor's technology on an exclusive basis in the specified territory of Country 1. The rights relating to the distribution and sale of Licensor products clearly fall within the scope of a § 1253(b)(1) franchise. Although a right to "manufacture" a product is not specifically listed in the § 1253(b)(1) definition of a franchise, here the right to use Licensor's patented information to manufacture Licensor products is integrally related to the other rights transferred under the agreement which clearly fall within the scope of § 1253(b)(1). As one court noted,

> Franchise agreements that provide the franchisee with the right to distribute products or to provide services in a particular area typically transfer to the franchisee rights to other intangible assets that are used in conducting the franchised business. Often these rights involve trademarks, trade names, technology, trade secrets, or patents . . . . Viewing a "transfer of a franchise" as encompassing only the transfer of the intangible right to distribute products and provide services and not also as including the transfer of other unique intangible assets integral to the provision of such products and related services produces a fundamentally inaccurate picture of the business relationship created by a franchise transfer.

Syncsort, 31 Ct. Cl. 545, 552 (1994).

In Syncsort, the taxpayer granted licensees the right to distribute a computer program, as well as the right to use trade secrets and technology to customize the programs for specific client use and to provide technical support to clients. The taxpayer argued that only the "naked right" to distribute the computer program was within the statutory definition of a franchise, and that the other assets transferred fell outside the scope of § 1253. The court disagreed, finding that all of the rights transferred were part of the business which constituted a franchise within the meaning of § 1253(b)(1). Likewise, all of the rights transferred under the License Agreement are part of the business of the distribution and sale of Licensor products, which constitute a franchise within the scope of § 1253(b)(1).

Accordingly, the only remaining issue is whether the payments made by taxpayer under the License Agreement are "contingent serial payments" under § 1253(d)(1).

Section 1253(d)(1) provides that any amount paid or incurred during the current taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name shall be allowed as a deduction under § 162(a) (relating to trade or business expenses) if the amount is: (1) contingent on the productivity, use, or disposition of the franchise, trademark, or trade name, and (2) is paid as part of a series of payments which are payable not less frequently than annually throughout the entire term of the transfer agreement, and which are substantially equal in amount (or payable under a fixed formula).

The License Agreement provides that Taxpayer must pay the following royalties to Licensor, which are payable in full in e day intervals: 1) c percent of net sales related to Licensed Products for the right to use the Technology and the technical services; 2) d percent of net sales related to Licensed Products for the right to use the Licensed Trademarks; 3) d percent of net sales related to Accessories (defined as items, articles, and devices bearing the Licensed Trademarks which are neither made in accordance with, nor embody or utilize the Technology and which are sold or used in conjunction with Licensed Products) for the use of the Licensed Trademarks; and 4) to the extent Taxpayer sublicenses the use of the Technology to third parties, b percent of net sales achieved by any such third party sublicensees with products based on the Technology.

The above royalties for use of the Licensed Trademarks and Technology are contingent on productivity or use because they are based on net sales. They are payable in full in e day intervals throughout the term of the agreement and are based on a fixed formula. Therefore, they constitute contingent serial payments under § 1253(d)(1).

Accordingly, based on the foregoing analysis and the representations made by Taxpayer, we rule that the amounts to be paid by Taxpayer to Licensor pursuant to the License Agreement will not be chargeable to capital account under § 197, pursuant to § 197(f)(4)(C) and the regulations thereunder, and will be currently deductible. No opinion is expressed on the correctness of whether the royalty payments to be made by Taxpayer to Licensor under the License Agreement represent arm's-length consideration.

In accordance with the power of attorney filed with this request, we are sending a copy of this letter ruling to Taxpayer and Taxpayer's second authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Harold E. Burghart
Assistant to the Chief, Branch 5
Office of Associate Chief Counsel, Passthroughs and Special Industries

cc: