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Memorandum

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from: Associate Area Counsel (Chicago, Group 2)
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subject: Character of Gain on Sale of Merchant Contracts

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent. This advice has been coordinated with National Office, Income Tax and Accounting, Branch 3.

<u>LEGEND</u>

Taxpayer =
a =
b =
c =

<u>ISSUE</u>

Whether the Taxpayer must recognize ordinary gain (versus capital gain) on the sale of certain merchant contracts for the taxable years ending on a through b.

<u>CONCLUSION</u>

Based upon the facts set forth below and for the reasons discussed herein, it is our opinion that the gain recognized by the Taxpayer for the taxable years ending on a through b on the sale of the merchant contracts constitutes ordinary income, not capital gain.

FACTS

The facts presented to us are as follows. The Taxpayer maintains relationships with merchants and provides servicing and clearing operations. The Taxpayer typically maintains a direct relationship with larger merchants. Between and , the Taxpayer sold part of its business relating to the direct merchant relationship with merchants to third party purchasers. These third party purchasers are in the business of consolidating servicing of transactions amongst multiple major providers, permitting a competitive advantage. The sale of these merchant contracts relating to merchants resulted in the recognition of significant taxable gains during the Taxpayer's taxable years ending on a through b. The Taxpayer originally reported taxable gains on the sale of the merchant contracts as ordinary income. The Taxpayer recently filed amended federal income tax returns for the taxable years ending on a through b recharacterizing the gains on the sale of the merchant contracts as capital, which are offset by capital losses arising in the taxable year ending on c. The position taken by the Taxpayer on the amended returns with respect to the gain on the sale of the merchant contracts will result in Joint Committee review.

The Taxpayer sold the merchant contracts pursuant to various Agreements (the "Agreements"). The Agreements convey and transfer the right, title and interest in a merchant servicing agreement and the books and records of each acquired merchant to the identified third party purchaser. Under the Agreements, the third party purchasers assume the obligations and liabilities of the Taxpayer arising out of the transactions entered into by the acquired merchant. In other words, the third party purchaser agrees to continue to service and provide activities on transactions with the transactions in the Taxpayer's trade name. The Agreements provide for an initial term of a specific number of years, along with renewal and termination provisions. The Taxpayer has provided sales data to Exam reflecting gross sales proceeds on the sale of the merchant contracts of $ and $ during and , respectively.

The Taxpayer's position is that the merchant contracts qualify as an IRC 1221 capital asset, as the merchant contracts are not excluded by the categories enumerated in IRC 1221(a)(1) through (8). The Taxpayer further asserts that the six factors, as identified in Foy v. Commissioner, 84 T.C. 50, 70 (1985), concerning the nature (capital gain versus ordinary income) of contract rights, weigh in favor of treating the merchant contracts as a capital asset. The Taxpayer states that any premium paid for the merchant contracts qualifies as goodwill or going concern value.

LAW AND ANALYSIS

The issue presented is whether the gain on the sale of the merchant contracts is ordinary income or capital gain from the sale of a capital asset. Section 1221 defines "capital asset" to mean "property held by a taxpayer (whether or not connected with his trade or business)," with the exception of the items described in IRC 1221(a)(1) through (8) including stock in trade, inventory, or property held by a taxpayer primarily for sale to customers in the ordinary course of business. Exam does not contend that any of the statutory exclusions apply to the contract rights at issue. Yet, the Supreme Court has held that not everything that can be called "property" in the ordinary sense, and outside the statutory exclusions in IRC 1221, qualifies as a capital asset as it does not include certain claims or rights to ordinary income. See Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134-136 (1960) (compensation for temporary seizure of business facilities is ordinary income).

Courts have imposed a limitation on property that qualifies as a capital asset in generally holding that a mere right to receive ordinary income does not qualify as a capital asset. See Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958). The prevailing view is that consideration received for the transfer of a contract right to receive income for the performance of personal services is taxable as ordinary income. In Commissioner v. Ferrer, the Second Circuit held that a taxpayer, who held a contractual right to produce a play which was exchanged for a right to receive a stated percentage of film proceeds, recognized ordinary income with respect to the right to receive a percentage of film proceeds. 304 F.2d 125 (2d. Cir. 1962).

Courts may also look to how the consideration received would have been taxed if there had been no assignment or sale of the contract. In Realty Loan Corporation v. Commissioner, the Tax Court held that the gain received on the sale of taxpayer's mortgage servicing business was not capital, as the rights to the servicing fees under the contracts was not a capital asset. 54 T.C. 83 (1970), aff'd 478 F.2d 1049 (9th Cir. 1973).

The sales of merchant business relationships, or accounts, represent the right to collect fees from the merchants for the performance of servicing and clearing operations. The sales of these relationships, or accounts, by the merchant contracts transferred pursuant to the Agreements represent the right to receive ordinary income. The Agreements reflect a term certain for the transfer of the accounts, with provisions for renewal or termination. The merchant contract rights do not constitute a capital asset. Accordingly, it is our opinion that the gain recognized by the Taxpayer on the sale of the merchant contracts constitutes ordinary income, not capital gain.

Additionally, the Foy factors used in analyzing whether contract rights constitute capital assets indicate that the merchant agreements transferred pursuant to the Agreements do not constitute capital assets. In Foy, the taxpayer created a nationwide network of janitorial franchises and sold the right to receive income in exchange for relief of obligations. The Tax Court identified the following six factors in determining whether the contract rights that were transferred constituted a capital asset: (1) how the contract rights originated; (2) how the contract rights were acquired; (3) whether the contract rights represented an equitable interest in property which itself constituted a capital asset; (4) whether the transfer of contract rights merely substituted the source from which the taxpayer otherwise would have received ordinary income; (5) whether significant investment risks were associated with the contract rights and, if so, whether they were included in the transfer; and (6) whether the contract rights primarily represented compensation for personal services. 84 T.C. at 70. It is unclear from the facts provided how the merchant contracts originated or were acquired by the Taxpayer. The contract rights do not represent an equitable interest in property which itself is a capital asset, instead the contract rights represent the right to receive ordinary income from the performance of and clearing operations. No significant investment risks have been identified with respect to the merchant contracts. As stated above, the contract rights in the merchant agreements represent compensation for personal services. Therefore, it is our opinion that the factors enumerated in Foy support our conclusion that the gain on the sale of the merchant contracts constitutes ordinary income, not capital gain.

With respect to the Taxpayer's claim that some portion of the gain on the sale of the merchant contracts is attributable to goodwill, this question is typically one of fact to be determined from the surrounding circumstances. A sale of goodwill attendant to the sale of a business may be treated as capital gain. Commissioner v. Killian, 314 F.2d 852 (5th Cir. 1963). Generally, a determination must be made whether a taxpayer has any continuing involvement in the operation of the business after the sale, and the nature of such involvement. This typically requires analysis of whether a taxpayer has any continuing control or enjoyment of the benefits of the goodwill. It is also necessary to identify whether the taxpayer has any right or option to repurchase the business in the future. Nonetheless, given our opinion that the sale of the merchant contracts does not relate to a capital asset, it is our view that no portion of the gain is attributable to goodwill.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (312) 368-8387 if you have any further questions.

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