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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JUNE Y. BASS
ASSOCIATE AREA COUNSEL, LMSB LAGUNA NIGUEL
(CC:LM:CTM:LN)

FROM: HEATHER C. MALOY
ASSOCIATE CHIEF COUNSEL (CC:ITA)

SUBJECT: Classification of Assets Sold

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LEGEND

Taxpayer 1 =
Taxpayer 2 =
Taxpayer 3 =
Taxpayer 4 =
Talent =
Principal =
Company A =
Company B =
Company C =
a =
b =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Year 1 =
Year 2 =
Year 3 =
Amount 1 =

ISSUE

Whether certain tangible and intangible assets are capital assets within the meaning of I.R.C. § 1221.

CONCLUSIONS

With minor adjustments, as detailed below, we concur in your determination as to the character of the tangible and intangible assets sold by the taxpayers.

FACTS

Talent is a talk show host. She has hosted a popular a program for approximately twenty years. The issues in this case stem from the sale of the show in Year 3.

Taxpayers 1, 2, 3 and 4, (collectively "the taxpayers"), are related entities. Principal is the sole shareholder of Taxpayers 1 and 2. Principal also owns Companies A and B. Taxpayer 3 is owned by Principal (40%), Taxpayer 2 (59%) and Company A (1%). On the sale date, 50% of Taxpayer 4 was owned by Company B, with the remaining 50% owned by two unrelated individuals.

At the time Talent's show was sold, it was owned by the taxpayers. Taxpayer 3 and Talent were parties to an employment contract whereby Taxpayer 3 employed Talent to be the on-air personality for the show.[1] Taxpayer 3 syndicated the show pursuant to a syndication agreement between Talent, Taxpayer 3 and Company C, the originating b for the show.

On Date 1, the taxpayers entered into an agreement to sell the show to unrelated third parties. The sale was treated as the sale of the component assets needed to produce the show. We understand the transaction was completed by the end of Year 3. The buyers hired an independent appraiser to value the assets as of Date 2. The stated purchase price in the sales contract was Amount 1. This reflects the appraised value for the assets less amounts the taxpayers allege were paid directly to Talent for her interests in her employment contract and the syndication agreement. The taxpayers' income tax returns for Year 3 reflect that the following assets were sold, respectively, in connection with the transaction:

Taxpayer 1
fixed assets
supply inventory

Taxpayer 2
production materials
Principal's non-competition agreement and covenant not to compete

Taxpayer 3
studio equipment
other fixed assets
program production materials
licensing and distribution rights
licensing rights
Talent contract
Principal's non-competition agreement and covenant not to compete

[1] Originally, Talent was employed by Company C. In Year 1 Company A acquired the contract. In Year 2, the contract was assigned to Taxpayer 2. Later, in Year 3, the employment contract, which was due to expire on Date 3, was assigned to Taxpayer 3.

Taxpayer 4
licensing and distribution rights (right of first refusal)
licensing and distribution rights
other fixed assets

We understand that, although the bulk of the show's assets were sold, Taxpayer 3 retained an interest in 50% of the international rights to market and exploit Talent's show outside the United States and Canada.

We believe the taxpayers have included different intangible assets within the items labeled as "licensing rights," "licensing and distribution rights" and "Talent contract." Our review of the information you provided suggests that the following assets may be included under these labels:

1. The overall right to license and distribute the show;
2. The syndication agreement between Talent, Taxpayer 3 and Company C;
3. Unexpired contracts between Taxpayer 3 and various b granting licenses to distribute the show in exchange for commercial air time (licensing agreements);
4. The contract or contracts between Taxpayers 2 and 4, whereby Taxpayer 4 agrees to be the exclusive sales representative for marketing the a air time received under the licensing agreements in exchange for commission income (sales representation agreements)[2];
5. The revenue participation agreement between Taxpayer 2 and Taxpayer 4. This agreement includes Taxpayer 4's right of first refusal, under which it had the option to meet any offer received by Company A for its rights to the show; and
6. Going concern value.

You have asked whether the various assets sold in connection with the disposition of the show are capital assets within the meaning of I.R.C. § 1221.

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[2] Although the facts are not entirely clear, it appears that Company A was originally obligated to Taxpayer 4 under the sales representation and revenue participation agreements. On Date 3, the rights and obligations under these agreements were assigned by Company A to Taxpayer 2.

LAW AND ANALYSIS

Section 1222 defines long-term capital gain as gain from the sale or exchange of a capital asset held for more than one year, if and to the extent such gain is taken into account in computing gross income.

Section 1221 defines the term "capital assets." The definition includes all classes of property not specifically excluded. For purposes of this case, the relevant exclusions set out in section 1221 are: (1) stock in trade or property held by the taxpayer primarily for sale in the ordinary course of business; (2) property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, or real property used in the trade or business; (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by certain specified taxpayers; (4) accounts or notes receivable acquired in the ordinary course of business for services rendered; and (5) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of business.

Section 1231(a)(3) provides that a section 1231 gain means any recognized gain on the sale or exchange or property used in the trade or business. If section 1231 gains exceed section 1231 losses, the gain and losses are treated as long-term capital gains or losses, as the case may be.

Section 1231(b) provides that the term "property used in the trade or business" means property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, held for more than one year, and real property used in the trade or business. Certain classes of property are excluded from the term "property used in the trade or business," including : (1) property of a kind which would properly be includible in inventory if on hand at the close of the taxable year; (2) property held by the taxpayer primarily for sale in the ordinary course of business; and (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221(a).

Miscellaneous Assets

We concur in your determination that the assets labeled as "fixed assets" or "other fixed assets" on the returns of Taxpayers 1 and 4 should be characterized as capital assets under section 1221, or treated as capital assets under section 1231. We also concur in your conclusions concerning promotional materials, supply inventory and Principal's non-competition agreement and covenant not to compete. The promotional materials and supply inventories are clearly excluded from the definition of capital assets under section 1221(1)[3]. It is also well settled that the amounts paid for a non-competition agreement, or covenant not to compete should be characterized as ordinary income. Horton v. Commissioner, 13 T.C. 143 (1949), acq., 1959-2 C.B. 5.

Program Production Materials

With respect to the program production materials, the issue is not quite so clear. We believe you may have an argument that these materials should be excluded from the definition of capital assets under section 1221(3) as a letter or memorandum, or similar property. In describing what constitutes "a letter or memorandum, or similar property," Treas. Reg. § 1.1221-1(c)(2) states that the phrase "similar property" includes property such as a draft of a speech, a manuscript, a research paper, an oral recording, a transcript of an oral interview or of dictation, a personal or business diary, a log or journal, a corporate archive, including a corporate charter, office correspondence, a financial record, a drawing, a photograph, or a dispatch. It is possible that some or all of the program production materials qualify as a business diary, a log or journal or a corporate archive.

In Chronicle Publishing Co. v. Commissioner, 97 T.C. 445 (1991), the issue was whether the taxpayer's contribution of a newspaper clippings library was subject to limitation under section 170(e). Section 170(e) reduces a charitable contribution of property by the sum of the amount of gain which would not have been long-term capital gain if the contributed property had been sold by the taxpayer at its fair market value. In Chronicle Publishing, the taxpayer argued that the clippings library was a capital asset because it was not an asset described in section 1221(a)(3).

The Tax Court indicated that the characterization of the library depended on whether it fell within the category of "a letter or memorandum, or similar property" described in section 1221(3). Chronicle Publishing, 97 T.C. at 448. The court cited Treas. Reg. § 1.1221-1(c)(2) with approval and relied on the regulation in analyzing whether the clippings library constituted similar property for purposes of section 1221(3). The court concluded that the library fell within the scope of a corporate archive and, therefore, in accordance with the regulation, was included within the phrase "similar property." Id. at 449-450.

We do not have sufficient facts about the program production materials to tell whether some or all constitute a business diary, log, journal, or corporate archive.

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[3] This provision is now designated section 1221(a)(1). In 1999, P.L. 106-170, Section 532(a)(1), substituted "(a) In general. For purposes" for "for purposes" in section 1221. In addition, new subsections (a)(6), (a)(7) and (a)(8) were added.

However, it appears that some of the materials, particularly the recordings, are sufficiently similar to the items in Chronicle Publishing to warrant further consideration. In this regard, you will need to consider when the materials were produced because the materials must be held by a taxpayer for whom such property was prepared or produced, or by a taxpayer in whose hands the basis of such property would be determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer for whom the property was prepared or produced. If it is determined that the program production materials are section 1221(3) assets, produced while the taxpayers owned the show, they should meet the taxpayer holding requirements of section 1221(3).

As a final matter, Treas. Reg. § 1.1221-1(c)(2) indicates that this subparagraph does not apply to property, such as a corporate archive, office correspondence, or a financial record, sold or disposed of as part of a going business if such property has no significant value separate and apart from its relation to and use in such business. In this case, the materials were sold as part of the sale of a going business; however, it is unclear whether they have significant value apart from their relation to and use in producing the show. If they do not, then the materials should qualify as capital assets or property used in the trade or business and the taxpayers are entitled to treat any gain from the sale of such materials as capital gain.

Licensing Rights

In Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962), the taxpayer obtained the exclusive dramatic production rights to a play based on “Moulin Rouge”, a novel based on the life of the artist Toulouse-Lautrec. The play and the novel were written by the same author. The terms of the contract called for production of the play within a certain period. The author retained motion picture, radio and television rights; however, the author was required to obtain written permission from the taxpayer to sell the motion picture rights during the contract term. In addition, the contract provided that the taxpayer would share in the proceeds of any motion picture, television or radio productions based on the play.

Shortly after the taxpayer and the author entered into the dramatic production contract, John Huston expressed an interest in producing a motion picture based on “Moulin Rouge.” Huston offered the lead role to the taxpayer and began the process of negotiating for the motion picture rights with the taxpayer and the author. Eventually, the parties agreed that the taxpayer would terminate his contract and the author would sell Huston all motion picture rights to his novel, including radio and television rights. The agreement called for the taxpayer to receive payment for acting services and to receive a percentage of the net profits from the distribution of the picture.

In 1953, the taxpayer received a total $287,779 from Huston's company. He reported $109,028 as ordinary income and the remainder, less expenses, as capital gain. The Commissioner took the position that the entire amount was ordinary income and the Tax Court agreed. The taxpayer appealed the decision.

The taxpayer argued that his contract with the author was property not excluded from the statutory definition of capital assets. Therefore, the termination of the contract constituted the disposal of a capital asset entitled to capital gains treatment.

The Second Circuit considered this analysis to be overly simplistic. The court considered various cases dealing with this issue and concluded that the common factor in cases held to come within the capital gain provision was that the taxpayer had either an estate in, an encumbrance on, or an option to acquire an interest in property. "In all these cases the taxpayer had something more than an opportunity afforded by contract, to obtain periodic receipts of income." Id. at 130.

The court considered the bundle of rights that were disposed of when the taxpayer agreed to terminate his contract with the author and concluded that the taxpayer had disposed of three different assets. First was the lease of the play. Second was his power to prevent disposition of the motion picture, radio and television rights during the contract term. Third was his interest in a share of the proceeds of a motion picture based on the play.

The court concluded that the taxpayer's interest in the lease of the play was equivalent to an equitable interest in the copyright. According to the court, this right was capital in nature and subject to capital gains treatment. The court considered the fact that there was no relationship between the amount the taxpayer received for surrender of his rights under the contract and the amount that would have been realized by retention of his rights. The court did not feel the fact that income from the play would have been ordinary was particularly relevant since the interest the taxpayer sold was more akin to an ownership interest in property.

The power to prevent any disposition of the motion picture, radio and television rights until after production of the play was also considered an equitable interest in a portion of the copyright. The court thought that relinquishing this right was analogous to a tenant relinquishing his right to prevent a landlord from leasing to another tenant in the same business and that it, similarly, should receive capital gains treatment.

The court, however, treated the taxpayer's right to a percentage of the proceeds of the motion picture and other rights differently. According to the contract between the taxpayer and the author, the taxpayer did not acquire an interest in the motion picture rights other that a right to receive a portion of the proceeds. Thus, the court concluded that the taxpayer's right to the proceeds represented an interest in an income stream rather than an interest in a capital asset. Disposal of this right resulted in ordinary income.

In King Broadcasting Co. v. Commissioner, 48 T.C. 542 (1967), the taxpayer was the successor-in-interest to a company that held an exclusive franchise from Muzak Corp. to transmit Muzak music to customers and subscribers in the state of Washington. In 1961, the taxpayer decided to sell to unrelated third parties certain assets, including its interest in the Muzak franchise. Instead of assigning rights under the existing franchise agreement, the taxpayer, the buyers and Muzak entered into an agreement under which the taxpayer's franchise was canceled and the buyers and Muzak entered into a new franchise agreement. The new agreement provided that, in the event of a default on the part of the buyers, the taxpayer would have the option of assuming the franchise agreement. An amount of $67,800 was allocated by the parties to the unexpired portion of the executory Muzak Program service agreements with the taxpayer's customers. The parties did not allocate any value to the Muzak franchise. The issue was the tax treatment of the $67,800, which was treated by the taxpayer as capital gain.

The taxpayer argued that the Muzak Program service agreements were capital assets under section 1221. It followed, according to the taxpayer that gain from the sale of the agreements should receive capital gain treatment. In the alternative, the taxpayer argued that the $67,800 represented the amount received in exchange for the transfer of the exclusive Muzak franchise to the buyers. The taxpayer argued that, as in Ferrer, the release of its rights under the franchise agreement should be viewed as the sale of a capital asset.

The Tax Court agreed that the franchise was in the nature of a capital asset. However, the court rejected the taxpayer's argument that the gain from the sale was entitled to capital gains treatment. The court focused on the fact that the parties had assigned the $67,800 to program service agreements. No part of the purchase price was assigned to the franchise. Although the Muzak franchise and the service agreements were clearly closely related, they were conceptually capable of being separated into two separate assets: a static intangible asset unproductive of income in and of itself (the franchise); and the product of the exploitation of the intangible asset (the program service agreements). King Broadcasting, 48 T.C. at 549-50. In contrast with Ferrer, the record did not make it clear that the parties to the sale intended to buy or sell rights in the franchise. Consequently the court concluded it was inappropriate to reallocate any part of the $67,800 to the franchise.

The court also concluded that the program service agreements did not qualify as capital assets. The court distinguished the program service agreements from the Muzak franchise and found that the agreements represented mere contractual opportunities to obtain periodic receipts of income. As such, income from the disposal of the agreements was ordinary.

As in Ferrer, the taxpayers in this case sold a bundle of rights when they sold their interests in the show. Unfortunately, the taxpayers have contributed to the confusion by identifying the assets on their income tax returns using different terms from those used by the appraiser. Moreover, it appears they have aggregated several different assets into broad categories. We believe what is labeled on Taxpayer 3's return as the Talent contract is the syndication agreement that originally existed between Talent, Company A and Company C. This contract probably encompasses the taxpayers' overall right to license and distribute the show. We conclude the taxpayers' overall right to license and distribute the show is a capital asset under Ferrer and King Broadcasting. This right is similar to the franchise rights in King Broadcasting and represents the taxpayers' equitable interest in the program. Accordingly, gain from the sale of the overall right to license the show is entitled to capital gains treatment.

The surrender of Taxpayer 4's right of first refusal is also entitled to capital gains treatment. We concur in your determination that the Taxpayer 4's right of first refusal is sufficiently similar to the taxpayer's power to prevent disposition of the motion picture, radio and television rights in Ferrer to warrant the same treatment.

In United States v. Snow, 223 F.2d 103 (9th Cir. 1955), the taxpayer was a partner in a produce and brokerage business. He decided to sell his 25% interest in the partnership, which included an interest in capital assets as well as a share in earnings and profits. He received $133,000 for his interest which represented his original investment of $71,000, plus $62,000 in undistributed earnings. The taxpayer entered into an agreement that purported to assign his interest in the $62,000 to the remaining partners. The receipt of the $133,000 was treated as proceeds from the sale of a capital asset. The trial court agreed with the taxpayer and the government appealed.

The government argued that the $133,000 included undistributed earnings of $62,000 that should be treated as ordinary income. The taxpayer argued that what was sold was an interest in the partnership. Because the property of the partnership was held by the partners as tenants in common, it should be treated as an indivisible whole. Thus, according to the taxpayer, the accrued income should be absorbed in the greater partnership interest rather than being treated separately.

The Ninth Circuit acknowledged that an interest in a partnership was a capital asset; however, the court went on to state: "It is a fundamental principle of federal tax law that you must regard any ordinary income derived from an income-producing capital asset as ordinary income." Id. at 108. According to the court, the right to receive ordinary income produced by a capital asset was not transmuted into a capital asset by the sale or assignment of the capital asset together with the right to receive the income. Only when the gain represented appreciation in the value of the capital asset was capital gains treatment appropriate.

In this case, prior to the date of sale, the taxpayers owned the syndication rights to the show. In order to exploit the show, Taxpayer 3 entered into agreements with b under which the b were licensed to broadcast the show in exchange for commercial air time. When the taxpayers sold the show, they conveyed the unexpired licensing agreements to the buyers. The gain from these unexpired contracts should be classified as ordinary.

The situation in this case is analogous to the situation in King Broadcasting, where the court distinguished between a static intangible asset unproductive of income in and of itself and the product of the exploitation of the intangible asset. In this case, the static intangible asset is Talent's show, or more specifically, the right to broadcast Talent's show. Like the program service agreements in King Broadcasting, the unexpired licensing agreements represent the product of the exploitation of the intangible asset. As such, the agreements merely provide a contractual opportunity to obtain periodic receipts of ordinary income.

This case also bears similarities to the Snow case. As in Snow, the taxpayers sold their overall interest in a business along with their interest in income from that business. In Snow, the income was already earned at the time of sale. This differs from the instant case where the agreements represented an interest in future income. However, we believe the principle is equally applicable that ordinary income derived from an income-producing capital asset should retain its character as ordinary income. In Snow, the Ninth Circuit rejected the taxpayer's attempt to turn ordinary income into a capital asset through the sale of the capital asset and the concurrent assignment of the right to receive income. We believe the outcome should be similar here. Rather than representing gain from the appreciation in value of a capital asset, the unexpired licensing agreements represent a right to receive ordinary income. The character of the income derived from the licensing agreements should not change merely because the taxpayers also sold the underlying capital asset. Accordingly, gain from the sale of the agreements should be ordinary.

The taxpayers also sold an agreement between Taxpayers 2 and 4 under which Taxpayer 4 received exclusive rights to act as the sales representative for the show.[4] Essentially, this agreement provided for the sale to third parties of the air

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[4] The copy of the contract we were provided indicates the parties to this agreement were Taxpayer 2 and 4. The sale of rights under the agreement, however, are reflected on the returns of Taxpayers 3 and 4. We assume that at some point prior

time received under the licensing agreements. Under this agreement, Taxpayer 4 was obligated to provide specified services in exchange for commission income. This agreement is labeled as licensing and distribution rights on the income returns for Taxpayers 3 and 4.

In Michot v. Commissioner, T.C. Memo. 1982-128, the Tax Court examined whether amounts received by a taxpayer for terminating franchising agreements should be characterized as long-term capital gain or ordinary income.

In 1958, and again in 1962, the taxpayer entered into agreements with Burger Chef Systems, Inc. Under these agreements, the taxpayer became the exclusive franchising agent for Burger Chef in Louisiana and Mississippi. The agreements gave the taxpayer the right to franchise the Burger Chef name and to sell franchises, equipment and products to franchisees in his territory. In accordance with the agreements, the taxpayer sold franchises to unrelated third parties. In addition, he purchased several stores on his own behalf, either directly or through wholly owned entities. For these stores, he was both the franchisor and the franchisee.

In 1968, General Foods acquired Burger Chef. General Foods wanted to terminate the taxpayer's employment as a franchising agent. In order to terminate the contracts, it filed suit. The matter was eventually settled in 1973. Under the terms of the settlement, the taxpayer agreed to cancel the two agreements and to waive any potential claim to disputed commissions. In return, the taxpayer received a total of $575,000 to be paid over a five-year period. The taxpayer reported the settlement proceeds as long-term capital gain.

The Commissioner argued the settlement proceeds were ordinary income. According to the Commissioner, the franchising agreements represented contract rights that did not rise to the level of property within the meaning of section 1221. Alternatively, the Commissioner argued the proceeds were merely a substitution for future ordinary income and that, therefore, gain should be characterized as ordinary income.

The Tax Court examined what the taxpayer gave up in the settlement and concluded he gave up four distinct assets: 1. his right to prevent franchisees, other than Burger Chef itself, from operating in his area; 2. his claim to certain disputed, but already earned income; 3. his right to commissions when any stores opened in the future; and 4. his right to future royalties from operating stores.

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to the sale of the show, Taxpayer 2 assigned its rights under the contract to Taxpayer 3.

The court considered and contrasted the taxpayer's right to commissions on the opening of future stores with his right to continuing royalties. The court was convinced that the right to future royalties was not primarily dependent on providing services. Instead, the court found the royalties were paid to the taxpayer as a result of his ownership interest as a franchisor. On the other hand, the court considered the right to commissions to be based on services provided by the taxpayer in support of the development of new Burger Chef stores. The amount of commissions per opening was set and did not vary based on the size of the store or other market factors. The court therefore concluded that in surrendering the right to commissions, the taxpayer essentially was giving up an ordinary income stream.

We believe Taxpayer 4's interest as the exclusive sales representative for the show is similar to the taxpayer's right to commissions in Michot. As in Michot, Taxpayer 4's agreement provided an opportunity to earn commissions in exchange for services in selling the air time received under the licensing agreements. Thus, by surrendering these rights, Taxpayer 4 gave up an ordinary income stream.

Taxpayer 3's interest in the agreement, however, is different. In Taxpayer 3's hands, the agreement is not a substitute for future ordinary income. Instead, the agreement represents a relinquishment of certain ownership rights. We believe Taxpayer 3's rights under this agreement were similar in nature to the taxpayer's continuing royalty interest in operating stores in Michot. Similarly, gain from the sale of such rights should receive capital gains treatment.

Going Concern Value

We understand the appraisal indicated a value for going concern value, but that this amount was not expressly reflected on any of the taxpayers' income tax returns. Going concern value is a valuable property right that qualifies as a capital asset for purposes of determining the tax treatment of gain. UFE, Inc. v. Commissioner, 92 T.C. 1314, 1323 (1989). We concur in your determination that gain from the sale of going concern value should receive capital gains treatment.[5]

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[5] As a technical point of clarification, we do not believe goodwill is equivalent to going concern value, although the terms often are used interchangeably. See UFE, Inc. v. Commissioner, 92 T.C. 1314 (1989); VGS Corp. v. Commissioner, 68 T.C. 563 (1977), acq., 1979-2 C.B. 2; Computing & Software, Inc. v. Commissioner, 64 T.C. 223 (1975), acq., 1976-2 C.B. 1. Goodwill is the expectation that old customers will return to the business. VGS Corp., 68 T.C. at 590. Going concern value is an additional element of value based on the ability of a business to continue to function and generate income without interruption as a consequence of the change in ownership of the business. Id. at 592.

TL-N-5217-00

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

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