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Department of the Treasury

Washington, DC 20224

Person to Contact:

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Legend:

Taxpayer =

Corporation =
Product A =
Product B =
State X =
a =
b =
c =
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f =
g =
h =
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Dear :

This letter responds to letter dated July 19, 2001, and additional correspondence, submitted on behalf of the Taxpayer as the Taxpayer's authorized representatives. The letter requests three rulings under sections 1221, 1241, and 453 of the Internal Revenue Code relating to certain payments received by the Taxpayer from Corporation.

The Taxpayer is an S corporation engaged in the business of selling and servicing Product A and Product B. The Taxpayer annual accounting period is the calendar year and it reports income and expenses using the accrual method of accounting.

The Taxpayer and Corporation entered into a distributorship's agreement that provided the Taxpayer with the right to sell and market Product A within a prescribed geographic area (Distributor Agreement). The Distributor Agreement provides that it may not be assigned to a third party. If a distributor sells its business (assets or stock), the selling distributor voluntarily terminates its distributor agreement with Corporation and Corporation subsequently approves the buyer under a new distributor agreement. The Taxpayer had the right to continually renew the Distributor Agreement as long as the Taxpayer performed according to the terms of the Distributor Agreement. In addition to being part of the Distributor Agreement, the renewal right was provided to the Taxpayer pursuant to State X law. The Taxpayer and Corporation last extended the Distributor Agreement on a.

Under the Distributor Agreement, the Taxpayer is obligated to maintain at least $i of net working capital at all times for the Product A and the Product B lines during its business operation and maintain the image of Corporation consistently with other distributors of Product A. The Distributor Agreement requires the Taxpayer to maintain and manage its distributorship so that it can effectively sell and service Product A. To do so, the Taxpayer is required to purchase and use Corporation designed equipment as necessary. The Taxpayer must service customers and maintain customer satisfaction. In addition, the Distributor Agreement requires that the Taxpayer must maintain a sufficient level of inventory to allow customers a variety of Product A. The Taxpayer's sales performance is monitored at least yearly and Corporation has the right to terminate the Distributor Agreement with the Taxpayer if it determines that the Taxpayer's sales performance is inadequate.

In b, Corporation notified the Taxpayer and other Product A distributors of its intention to discontinue the Product A line. As part of this announcement, Corporation offered to provide transition payments to distributors who agreed to cancel their distributor agreements with Corporation. The calculations of the transition payments are based upon a number of factors including the number of Product A sold by the distributor over a three-year period and the percentage of Product A sold out of total

sales by the distributor. The cancellation would also entail a release of Corporation from any future claim brought under a distributor agreement.

On c, the Taxpayer and Corporation agreed to cancel the Distributor Agreement and executed a Transition and Release Agreement (TRA) setting forth the terms of the cancellation. The TRA provided for d percent of the transition payment amount of $h to be paid to the Taxpayer upon the execution of the TRA and the remaining amount upon the earliest of three dates: (1) e days after the Taxpayer provides notice to Corporation of its intention to no longer sell and market Product A; (2) f months after Corporation provides notice to the Taxpayer of its intention to eliminate the Taxpayer's ability to sell, market, and service Product A; or (3) g. Under the terms of the TRA, the Taxpayer may continue to sell and market Product A until the earliest of the three dates. One or more of the transition payments will be received by the Taxpayer after the close of the taxable year in which the disposition occurs. As of j, the Taxpayer had an inventory of approximately $k relating to the Product A line and gross revenue in m of approximately $l relating to the Product A line.

The first ruling involves whether § 1241 applies to the TRA between the Taxpayer and Corporation so that the cancellation of the Distributor Agreement is considered an exchange.

Section 1241 provides that amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), shall be considered as amounts received in exchange for such lease or agreement.

Section 1.1241-1(a) provides, in general, that proceeds received by lessees or distributors from the cancellation of leases or of certain distributorship agreements are considered as amounts received in exchange therefor. Section 1241 has no application in determining whether or not a cancellation not qualifying under that section is a sale or exchange. Further, § 1241 has no application in determining whether or not a lease or a distributorship agreement is a capital asset, even though its cancellation qualifies as an exchange under § 1241.

Section 1.1241-1(b) defines "cancellation" of a lease or a distributor's agreement, as used in § 1241, to mean a termination of all the contractual rights of a lessee or distributor with respect to particular premises or a particular distributorship, other than by the expiration of the lease or agreement in accordance with its terms. A payment made in good faith for a partial cancellation of a lease or a distributorship agreement is recognized as an amount received for cancellation under § 1241 if the cancellation relates to a severable economic unit, such as a portion of the premises covered by a lease, a reduction in the unexpired term of a lease or distributorship agreement, or a distributorship in one of several areas or of one of several products.

Payments made for other modifications of leases or distributorship agreements, however, are not recognized as amounts received for cancellation under § 1241.

Section 1.1241-1(c) provides that § 1241 applies to distributorship agreements only if they are for marketing or marketing and servicing of goods. It does not apply to agreements for selling intangible property or for rendering personal services as, for example, agreements establishing insurance agencies or agencies for the brokerage of securities. Further, it applies to a distributorship agreement only if the distributor has made a substantial investment of capital in the distributorship. The substantial capital investment must be reflected in physical assets such as inventories of tangible goods, equipment, machinery, storage facilities, or similar property. An investment is not considered substantial for purposes of § 1241 unless it consists of a significant fraction or more of the facilities for storing, transporting, processing, or otherwise dealing with the goods distributed, or consists of a substantial inventory of such goods. The investment required in the maintenance of an office merely for clerical operations is not considered substantial for purposes of this section. Furthermore, § 1241 does not apply unless a substantial amount of the capital or assets needed for carrying on the operations of a distributorship are acquired by the distributor and actually used in carrying on the distributorship at some time before the cancellation of the distributorship agreement. It is immaterial for the purposes of § 1241 whether the distributor acquired the assets used in performing the functions of the distributorship before or after beginning his operations under the distributorship agreement. It is also immaterial whether the distributor is a retailer, wholesaler, jobber, or other type of distributor.

In order for § 1241 to apply to the transition payments received by the Taxpayer from Corporation, the Taxpayer must be a distributor of goods; the transition payments received by the Taxpayer must be for a cancellation of a distributor's agreement; and the Taxpayer must have a substantial capital investment in the distributorship. The Distributor Agreement provides that the Taxpayer may sell Product A, which is not an intangible or a personal service, within a certain defined geographic area and the Taxpayer has made a substantial investment of capital in the distributorship as evidenced by the inventory value of approximately $k as of j. Under § 1.1241-1(b), a cancellation of a distributor's agreement means a termination of all contractual rights of a distributor for a particular distributorship. The TRA terminates all of the Taxpayer's contractual rights over time (no later than g) to sell new Product A. Therefore, the transition payments received by the Taxpayer from Corporation under the TRA are considered amounts received in exchange for a distributor's agreement under § 1241.

The second ruling involves whether the exchange shall be considered long-term capital gain to the Taxpayer.

In order for proceeds from the disposition of an asset to qualify as long-term capital gain, the asset must be a capital asset as defined by § 1221, the disposition must be a "sale or exchange," and the asset must have been held for more than one

year. § 1222. Under § 1231, capital gain treatment also may result from the sale or exchange of real or depreciable property used in the taxpayer's trade or business and held for more than one year, if the taxpayer's § 1231 gains exceed its § 1231 losses for the year.

Thus, in order for the Taxpayer to get capital gains treatment for gain it realizes upon the cancellation of its distributorship, three requirements must be met: (1) the Taxpayer must have held the distributorship for more than one year; (2) there must be a sale or exchange upon cancellation of the distributorship; and (3) the Distributor Agreement must be an asset that qualifies for capital gain treatment under either § 1221 or § 1231.

In this case, the first requirement has been met because the Taxpayer has held the distributorship for more than one year. The second requirement that there be a sale or exchange upon the cancellation of taxpayer's distributorship agreement has been satisfied because, under § 1241, amounts received by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), shall be considered as amounts received in exchange for such agreement.[1]

We look, then, to the third requirement, that the distributorship must be an asset that qualifies for capital gain treatment under either § 1221 or § 1231. Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of five listed exceptions: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in § 167 or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; and (5) certain publications of the United States Government.

The term "section 1231 gain" includes gain from the sale or exchange of property used in a taxpayer's trade or business, of a character which is subject to the allowance for depreciation under § 167, and that does not fall within certain exceptions generally equivalent to the exceptions in § 1221.

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1. Over the years, Congress has enacted numerous "statutory sale or exchange" provisions that provide for capital gain or loss in many situations, including § 1241 with respect to cancellation of leases and certain distributorship agreements. See, e.g., §§ 165(g), 166(d)(1)(B) (worthless securities); 1038 (foreclosures); 1231(a)(3) (involuntary conversions; overruling Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941)); 1233 (short sales); 1234 (option expirations); 1234A (certain contract cancellations); 1271 (debt retirements).

In this case, the Distributor Agreement is an asset used in the Taxpayer's trade or business that does not fall within any of the listed exceptions to capital gain treatment in § 1221 or § 1231. We need not decide whether it is a capital asset or a section 1231 asset because, in either case, gain from the sale or exchange of such an asset would be capital gain for Taxpayer. We conclude that the gain calculated upon the exchange will be considered long-term capital gain to the taxpayer within the meaning of §§ 1221 or 1231.

The third ruling involves whether the Taxpayer's income from the cancellation may be taken into account under the installment sales method of § 453.

Section 453(a) states that, except as otherwise provided, income from an installment sale shall be taken into account under the installment method, which is defined in § 453(c). Section 453(b)(1) defines an installment sale as a disposition of property if at least one payment is to be received after the close of the taxable year in which the disposition occurs.

Rev. Rul. 55-374, 1955-1 C.B. 370, deals with the sale of a taxpayer's rights under a distributorship agreement. The taxpayer represented foreign manufacturers and was appointed by a foreign company as the sales and distribution agent for its products. The taxpayer then sold his rights in the distributorship agreement to a third party. A portion of the sales price was paid in the year the sales agreement was executed and the balance was paid in the following year. The revenue ruling holds, in part, that the sale was a sale of property the gain from which could be reported on the installment basis under the predecessor of § 453. See also Fox v. Commissioner, 84 T.C. 50, in which the Tax Court held that the proceeds received from the sale of a janitorial and building maintenance franchise network qualified under § 453 for the installment method of reporting.

The transition payments received by the Taxpayer for the cancellation of the Distributor Agreement under the TRA are considered amounts received in exchange for such agreement, and accordingly, the cancellation will qualify as a disposition for purposes of § 453, The Distributor Agreement constitutes property within the meaning of § 453. Thus, the Taxpayer's income from the cancellation may be taken into account under the installment method of § 453.

Accordingly, based upon the above facts and legal analysis, we rule as follows:

(1) The transition payments received by the Taxpayer are considered amounts received in exchange for the cancellation of Taxpayer's Distributor Agreement pursuant to § 1241;

(2) The gain calculated upon the exchange will be considered long-term capital gain to the taxpayer within the meaning of §§ 1221 or 1231; and

(3) Because at least one transition payment will be received by the Taxpayer after the year of disposition, the Taxpayer is eligible to report the gain from the exchange on the installment method pursuant to § 453.

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations.

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

In accordance with the power of attorney on file, a copy of this letter is being sent to the Taxpayer.

Sincerely yours,
SUSAN J. REAMAN
Chief, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures:
6110 copy
Copy of Letter