Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID #
Telephone Number:

Refer Reply To:
CC:CORP:1 – PLR-145847-03

Date:
December 04, 2003

In Re:

Legend:

Parent =

Subsidiary =

Date A =

Dear

This letter is in reply to your letter dated July 28, 2003, requesting rulings on behalf of Parent regarding the proper treatment under section 1374 of the Internal Revenue Code of the grant or transfer of certain franchise rights to franchisees.

Parent is a holding company that wholly owns Subsidiary. Parent and Subsidiary are subchapter C corporations that use the accrual method of accounting.

Subsidiary is engaged in a franchise business. Subsidiary enters into agreements with franchisees ("Agreements") for a specified period of years. Pursuant to these Agreements, Subsidiary grants franchisees use of a license to establish and operate a franchise, along with the right to use certain trademarks and the operational system for running the franchise. Franchisees pay Subsidiary a license fee upon grant of the license and monthly royalty fees which are composed of a fixed fee portion and a variable fee portion. Except for the limited use allowed by the Agreements, Subsidiary retains a

significant power, right, or continuing interest in the franchise and terminates any Agreement in violation of the terms and conditions of the license grant. The grant or transfer of franchise rights pursuant to an Agreement does not constitute a sale or exchange of a capital asset under section 1253(a).

Parent proposes to elect under section 1362(a) to be treated as an S corporation within the meaning of section 1361 effective for the tax year beginning on Date A (the "Conversion Date"). Parent also proposes to elect to treat Subsidiary as a qualified subchapter S subsidiary under 1361(b)(3)(B) effective for the tax year beginning on the Conversion Date.

Based solely on the information submitted, we rule as follows:

The income of Parent with respect to the receipt of the license fees and royalty fees from franchisees after the Conversion Date will not be treated as recognized built-in gain within the meaning of section 1374(d).

We express no opinion about the tax treatment of the license fees or royalty fees under other provisions of the Code and regulations or the tax treatment of any conditions existing at the time of, or the effects resulting from, the license fees and royalty fees that are not specifically covered by the above ruling. We also express no opinion about the tax treatment under 1374 of any income or gain that may be realized by Parent during the recognition period except as specifically provided above.

This ruling letter is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. A copy of this letter must be attached to Parent's federal income tax returns for Parent's final year as a C corporation and for each recognition period year in which the Parent receives license fees or royalty fees pursuant to an Agreement.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

Michael J. Wilder
Michael J. Wilder
Senior Technician Reviewer, Branch 1
Office of Associate Chief Counsel
(Corporate)