Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
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Refer Reply To:
CC:ITA:B06
PLR-132688-12

Date:
January 24, 2013

In Re: Request for Rulings under §§ 167, 197 and 263(a).

Taxpayer =

Parent =

Predecessor =

Franchisee =

Party 1 =

Termination Payment =

Process =

Technology 1 =

Technology 2 =

Product 1 =

Product 2	=	
Industry	=	
State 1	=	
State 2	=	
State 3	=	
Date 1	=	
Date 2	=	
Date 3	=	
Date 4	=	
Date 5	=	
Date 6	=	
Year 1	=	
Year 2	=	
Year 3	=	
A	=	
B	=	

Dear :

This letter is in response to your letter dated Date 1, and subsequent correspondence, submitted on behalf of Taxpayer, requesting a letter ruling on whether Taxpayer must capitalize a termination payment made by Taxpayer to Franchisee pursuant to § 1.263(a)-4(d)(7) of the Income Tax Regulations and whether Taxpayer's termination payment is properly amortizable over the duration of the franchisee's original useful life of the intangible asset using the remaining portion of the 15 year statutory life established under § 197 of the Internal Revenue Code.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer is a U.S. corporation, organized and existing under the laws of State 1 and having its principal office in State 2, and is a subsidiary of Parent. Taxpayer is a global leader in Process for Industry. Taxpayer developed certain technology capabilities for use in Industry, including Technology 1. Prior to entering into the agreements described below, Taxpayer primarily operated in State 3 and did not have the capacity to operate effectively in other areas.

On Date 2, Taxpayer entered into a franchise agreement with Predecessor, the predecessor in interest to Franchisee, whereby Predecessor acquired exclusive rights constituting a franchise as defined in § 1253(b)(1) to distribute, sell, or provide goods, services, or facilities worldwide in connection with Product 1. This agreement was perpetual and would not be terminated except upon certain events. Taxpayer and Franchisee amended the agreement on different occasions to change certain terms.

On Date 3, Taxpayer entered into a separate franchise agreement with Franchisee whereby Franchisee acquired exclusive rights constituting a franchise as defined in § 1253(b)(1) to distribute, sell, or provide goods, services, or facilities worldwide in connection with Product 2. This agreement was for a term of A years, thereafter perpetually renewable in 1 year increments provided that Taxpayer and Franchisee agreed in writing to an extension not less than B days before the end of the term. Additionally, this agreement could be terminated by Taxpayer or Franchisee upon certain events, or unilaterally by Taxpayer with written notice to Franchisee upon certain other events. Taxpayer and Franchisee amended and restated the agreement to change certain terms.

In Year 3, Taxpayer's management determined that Taxpayer could increase profits by removing Franchisee from the distribution channel and either selling directly to end-users, or by seeking a partnership with another company.

On Date 4, Taxpayer and Franchisee mutually agreed to terminate their existing contractual relationship. In accordance with the termination agreement, Taxpayer was required to pay the Termination Payment for, among other reasons, the termination of all contractual agreements previously entered into by Taxpayer and Franchisee. Taxpayer's ruling request relates only to the portion of the Termination Payment that is allocable to the termination of the agreements entered into on Dates 2 and 3. Taxpayer's ruling request does not relate to the portion of the Termination Payment that is allocable to other items such as the purchase of tangible assets or any non-compete agreement. Also, Taxpayer did not as a result of the termination agreement, pay for the acquisition of assets constituting a trade or business or substantial portion thereof.

RULINGS REQUESTED

Taxpayer requests that the Internal Revenue Service issue the following rulings:

1. The portion of the Termination Payment made by Taxpayer to Franchisee that is allocable to the termination of the agreement entered into on Date 2, is properly amortizable over the duration of Franchisee's original useful life of the intangible asset (using the statutory life of 15 years under § 197) when said intangible asset was created in Year 1. Thus, because that useful life has elapsed under statute, the Termination Payment, although capital under § 1.263(a)-4(d)(7), should be fully amortized in the period in which it was made.

2. The portion of the Termination Payment made by Taxpayer to Franchisee that is allocable to the termination of the agreement entered into on Date 3, is properly amortizable over the duration of Franchisee's original useful life of the intangible asset (using the statutory life of 15 years under § 197) when said intangible asset was created in Year 2. Thus, Taxpayer is entitled to amortize the portion of the Termination Payment allocable to the agreement entered into on Date 3, ratably over the period beginning with Date 5, through the calendar tax year ended Date 6.

LAW AND ANALYSIS

Section 263(a) provides generally that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate or any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 1.263(a)-4 provides rules for applying § 263 to amounts paid to acquire or create intangibles. Section 1.263(a)-4(b)(1) provides that except as otherwise provided in § 1.263(a)-4, a taxpayer must capitalize an amount paid to: (i) acquire an intangible (see § 1.263(a)-4(c)); (ii) create an intangible described in § 1.263(a)-4(d); (iii) create or enhance a separate and distinct intangible asset within the meaning of § 1.263(a)-4(b)(3); (iv) create or enhance a future benefit identified in the Federal Register or the Internal Revenue Bulletin as an intangible for which capitalization is required; and (v) facilitate (as defined in § 1.263(a)-4(e)(1)) the acquisition or creation of an intangible.

Section 1.263(a)-4(c)(1) provides, in part, that a taxpayer must capitalize an amount paid to another party to acquire any intangible from that party in a purchase or similar transaction. Specifically, § 1.263(a)-4(c)(1)(viii) provides that a taxpayer must capitalize amounts paid to another party to acquire a franchise, trademark or trade name (as defined in § 1.197-2(b)(10)).

Section 1.263(a)-4(d)(1) provides a general rule that a taxpayer must capitalize amounts paid to create an intangible described in § 1.263(a)-4(d). See also § 1.263(a)-4(b)(1)(ii).

Section 1.263(a)-4(d)(7)(i) provides that a taxpayer must capitalize amounts paid to another party to terminate certain agreements: (A) a lease of real or tangible personal property between the taxpayer and that party; (B) an agreement that grants that party the exclusive right to acquire or use the taxpayer's property or services to conduct the taxpayer's business; or (C) an agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party. In this case, Taxpayer terminated its two franchise agreements with Franchisee. Because the original agreements granted Franchisee exclusive rights to use Taxpayer's property to conduct Taxpayer's business, the Termination Payment made by Taxpayer to Franchisee created new intangible assets under § 1.263(a)-4(d)(7)(i)(B). An issue, however, remains as to whether it could also be construed that Taxpayer acquired one or more franchises under § 1.263(a)-4(c)(1)(viii). Because of the different treatment of the two types of intangibles generally, and the application of different rules (e.g., the 12-month rule does not apply to acquired intangibles, etc) it is necessary to assign a particular expenditure into one of the categories in § 1.263(a)-4.

Section 1.263(a)-4(d)(7) uses explicit language to describe the types of transactions for its application. In this case, Taxpayer's contract terminations clearly fall under those described in § 1.263(a)-4(d)(7)(i)(B). *See also* § 1.263(a)-4(d)(7)(iii), *Examples 1* and *2*. While § 1253(b)(1) defines the term "franchise" as 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, the termination agreement did not create a new agreement to acquire a franchise under § 1253(b)(1) in this respect. The legal effect of the agreement to terminate the relationship between Taxpayer and Franchisee was to extinguish agreements giving one party the exclusive right to distribute product in a specified territory.

Accordingly, the Termination Payment made by Taxpayer is required to be capitalized as created intangible assets under § 1.263(a)-4(d)(7)(i)(B) and not as acquired intangible assets under § 1.263(a)-4(c)(1)(viii). The remaining question is whether Taxpayer may recover the Termination Payment under § 167 or § 197.

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the taxpayer's trade or business.

Section 1.167(a)-3(a) provides in pertinent part that if an intangible is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Section 1.167(a)-3(a) further provides that no allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. Section 1.167(a)-3(b) provides a 15-year useful life safe harbor for certain intangible assets with indeterminable useful lives, beginning on the first day of the month in which the intangible is placed into service.

The Tax Court in *Rodeway Inns of America v. Commissioner*, 63 T.C. 414 (1974) held that a taxpayer's payment to terminate the exclusive right that the taxpayer had previously granted to another person to develop the taxpayer's motel chain in four states was depreciable under § 167 over the remaining useful life of the original agreement. The capital expenditure is properly amortizable over the remaining useful life of the original agreement because it is made to obtain the asset held by another person, that is, an asset limited by the terms of the original agreement. *See Rodeway*, 63 T.C. at 421-22. While the terms of the territorial agreement in *Rodeway* provided for its continuance for as long as 24 years and 22 months after the date on which it was cancelled, the Court determined that the agreement's remaining useful life was 5 years, because all desirable locations for motels would be taken within that time. *Id.* at 422-23.

Section 197(a) provides that a taxpayer shall be entitled to an amortization deduction with respect to any amortizable § 197 intangible. Section 197(b) provides that no other depreciation or amortization deduction shall be allowable with respect to any amortizable § 197 intangible. The amount of the deduction under § 197 is determined by amortizing the adjusted basis of such intangible ratably over the 15-year period beginning with the month in which the intangible was acquired.

The term "section 197 intangible" is defined in § 197(d) and the regulations thereunder. Intangible assets not described in § 197(d) or the regulations thereunder may not be amortized under § 197. Further, § 197(c)(2) provides that the term "amortizable section 197 intangible" does not include any § 197 intangible that is not described in § 197(d)(1)(D), (E), or (F), and that is created by the taxpayer, unless the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Section 1.197-2(d)(2)(ii) states, in part, that a § 197 intangible is created by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs for its creation, production, development, or improvement.

Taxpayer represents that it did not acquire assets constituting the acquisition of a trade or business or a substantial portion thereof. We note, however, that Taxpayer did not provide a list of the intangible assets, or interest therein, acquired or reacquired by Taxpayer upon entering into the termination agreement despite our request that Taxpayer provide such list. Consequently we cannot determine whether Taxpayer acquired or reacquired any § 197 intangibles that constitute the acquisition of a trade or business or a substantial portion thereof, e.g. any trademarks. Therefore, Taxpayer must depreciate the Termination Payment, if at all, under § 167.

The Service will ordinarily not rule on the useful life of assets for purposes of § 167. See section 4.01(12) of Rev. Proc. 2013-3, 2013-1 IRB 113, 119. Nonetheless, we note that the Termination Payment is allocable, in part, to a perpetual agreement. If the useful life of the intangible asset created upon the termination of the perpetual agreement cannot be estimated with reasonable accuracy, Taxpayer may avail itself of the safe harbor in § 1.167(a)-3(b). However, despite Taxpayer's arguments to the contrary, Taxpayer may not use Franchisee's remaining statutory life of either franchise under § 197. Section 197 does not establish a useful life for purposes of the depreciation deduction under § 167(a).

CONCLUSION

Based solely on the facts and representations submitted and the relevant law and analysis as set forth above, we conclude that the Termination Payment (1) is capitalizable under § 1.263(a)-4(d)(7)(i)(B) and (2) is not properly amortizable over the duration of Franchisee's original useful life of the intangible assets (using the statutory life of 15 years under § 197) when said intangible assets were created. We conclude that the Termination Payment may be recovered under § 167(a) if Taxpayer knows from experience or other factors that the intangibles assets are of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy or, if not, under § 1.167(a)-3(b).

We understand that Taxpayer already took the position that they requested in this letter ruling on their originally filed Year 3 federal tax return. Accordingly, Taxpayer should assess whether it needs to amend its Year 3 federal tax return to become compliant with the conclusions in this letter ruling. If Taxpayer determines that it must amend its Year 3 federal tax return, it should attach a copy of this letter ruling with its amended return.

Except as set forth above, we express no opinion concerning the Federal income tax consequences of the facts described above under any other provisions of the Code. Specifically, no opinion is expressed or implied on (i) whether the intangibles have reasonably ascertainable value and a limited useful life; (ii) whether the portion of the Termination Payment that that Taxpayer allocated to the termination of the agreements entered into on Dates 2 and 3 is correct; (iii) whether any agreements not referenced above affect the proper characterization of the transactions for federal tax purposes; and (iv) whether Taxpayer acquired any § 197 intangibles.

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

In accordance with the power of attorney, we are sending copies of this letter to Taxpayer's authorized representative. We are also sending a copy of this letter to the appropriate operating division director.

Sincerely,

Patrick M. Clinton

Patrick M. Clinton
Assistant to the Branch Chief, Branch 7
(Income Tax & Accounting)

Enclosures (2):
copy of this letter
copy for section 6110 purposes