

Part I

Section 1221.-- Capital Asset Defined

26 CFR 1.1221-1: Meaning of terms.
(Also §§ 197, 1231, 1241, 1245, 1253; 1.1241-1.)

Rev. Rul. 2007-37

ISSUE

1. Is the cancellation of a distributor agreement between a manufacturer and a distributor of the manufacturer's products a sale or exchange of property?
2. Is any resulting gain to the distributor capital gain or treated as capital gain?

FACTS

X manufactures automobile N. X sells N through a network of automobile distributors with which X enters into distributor agreements. The distributor agreements generally provide that a distributor may sell N within a prescribed geographic area and may renew the agreement as long as the distributor performs according to the agreement.

In 1994, A entered into a distributor agreement with X to sell N. The amount of A's payment to X for the agreement is not contingent on the productivity, use, or disposition of the right to sell N, but rather is a fixed sum. Since then, A has been continuously engaged in the trade or business of selling N. A makes a substantial

capital investment in its distributorship as reflected in the cost of its N inventory.

X plans to discontinue production of N in 2007, and offers payments to distributors to cancel their N distributor agreements. In 2007, A accepts X=s payment of \$40x in cancellation of its N distributor agreement with X. A=s basis in the distributor agreement is \$10x. A has no section 1231 losses.

LAW

Section 1241 of the Internal Revenue Code provides that amounts received by a distributor of goods for the cancellation of a distributor agreement in which the distributor has a substantial capital investment are amounts received in exchange for the agreement. Section 1.1241-1(b) of the Income Tax Regulations defines a cancellation of a distributor agreement as a termination of all the contractual rights of a distributor with respect to a particular distributorship, other than by the expiration of the agreement in accordance with its terms.

Section 1.1241-1(c) provides that ' 1241 applies to a distributor agreement only if (i) it is for marketing or marketing and servicing of goods, (ii) the distributor has made a substantial capital investment in the distributorship, and (iii) the capital investment is reflected in physical assets such as inventories of tangible goods, equipment, machinery, storage facilities, or similar property.

Section 1221 defines "capital asset" as property held by the taxpayer, whether or not it is connected with the taxpayer's trade or business. However, property used in a taxpayer=s trade or business and of a character that is subject to the allowance for depreciation provided in ' 167 is not a capital asset. Section 1221(a)(2).

Under ' 1231, gain from the sale or exchange of property that is not a capital asset may be treated as capital gain if the property is used in the trade or business, is held for more than one year, and is property of a character subject to the allowance for depreciation under ' 167. If a taxpayer has a net gain for a taxable year from sales or exchanges of property used in the trade or business as defined in ' 1231(b) (as well as from certain involuntary conversions of property), each gain or loss from such sales or exchanges is treated under § 1231(a)(1) as a long-term capital gain or loss. If a net loss results, each gain or loss is treated under § 1231(a)(2) as not arising from the sale or exchange of a capital asset. Generally, the result of the operation of ' 1231 in a taxable year is to give the taxpayer the benefit of long-term capital gains treatment on net gains and ordinary loss treatment on net losses. However, ' 1231(c) provides that the net section 1231 gain for any taxable year is treated as ordinary income to the extent of the taxpayer=s non-recaptured net section 1231 losses for the five most recent preceding taxable years.

Since section 1231 gain includes gain from the sale or exchange of property of a character subject to an allowance for depreciation under § 167, section 1231 gain may be subject to recapture under ' 1245. Section 1245 provides for recapture of depreciation and amortization if the property sold or exchanged is section 1245 property. Section 1245 property includes any personal property, including intangible personal property, of a character subject to the allowance for depreciation under ' 167. See ' 1245(a)(3)(A) and ' 1.1245-3(b)(2).

Franchises subject to ' 197

Under § 197(f)(7), property that is an amortizable section 197 intangible is treated as property of a character subject to the allowance for depreciation under § 167.

An amortizable section 197 intangible is any section 197 intangible that is acquired by the taxpayer on or after the effective date of § 197 (in general, August 11, 1993; or July 26, 1991, if there is a valid retroactive election under § 1.197-1T) and is held in connection with the conduct of a trade or business. Section 197(c)(1) and § 13261(g)(2) of Pub. L. No. 103-66. Under § 197(d)(1)(F), a section 197 intangible includes any franchise, trademark, or trade name. Section 197(f)(4) defines the term franchise by reference to § 1253(b)(1), which provides that a franchise includes an agreement that gives the right to sell goods within a specified area.

Since an amortizable section 197 intangible, including a franchise, is property of a character subject to an allowance for depreciation under § 167, it is not a capital asset for purposes of § 1221. However, if an amortizable section 197 intangible is used in a trade or business and held for more than one year, gain or loss on its sale or exchange generally qualifies as a section 1231 gain or loss. Similarly, an amortizable section 197 intangible is section 1245 property and any section 1231 gain from the sale or exchange of an amortizable section 197 intangible may be subject to recapture under § 1245.

Franchises acquired on or after January 1, 1970, and before the effective date of § 197

Whether a franchise acquired on or after January 1, 1970 (the effective date of § 1253), and before the effective date of § 197, is a capital asset under § 1221 or section 1231(b) property depends on whether the franchise is amortizable under § 1253 and whether, because of such amortization, it is property of a character subject to the

allowance for depreciation under ' 167. For this purpose, the relevant provisions of ' 1253 are those in effect before its amendment in 1993, and references to ' 1253 in this section of this revenue ruling are to the provisions in effect before its 1993 amendment.

In general, intangible assets acquired before the effective date of ' 197 could be amortized only if they had a limited useful life, the length of which could be estimated with reasonable accuracy. Section 1.167(a)-3. Although franchises in many cases have indefinite useful lives, ' 1253 allowed the cost of franchises in which the transferor retained any significant power, right, or continuing interest to be either deducted in the taxable year paid or amortized over a specified period of time. Section 1253(d)(1), which was not affected by the 1993 amendment, provides that a purchaser of a franchise may deduct certain contingent payments under ' 162(a). Section 1253(d)(2) provided that payments not deductible under ' 1253(d)(1) were recoverable over a period of time that depended on whether the payments were made in a lump sum, in approximately equal installments over a specified period, or under another payment arrangement. For transfers after October 2, 1989, ' 1253(d)(2) did not apply if the transfer of the franchise involved principal payments in excess of \$100,000, but the taxpayer could elect under ' 1253(d)(3) to recover the cost of the franchise ratably over a 25-year period beginning with the taxable year of the transfer. Thus, although ' 1253 did not explicitly provide that a franchise was treated as property of a character subject to the allowance for depreciation, it permitted acquisition costs to be amortized as if the franchise had a limited useful life.

Property amortizable under provisions of the Code other than § 167 has been

held to be a property of a character which is subject to the allowance for depreciation under § 167 and § 1231(b) property. See Tom F. Baker v. Commissioner, 38 T.C. 9 (1962); McEnery v. Commissioner, T.C. Memo. 1967-213. It has long been established that an amortizable item is of a character subject to depreciation as required under § 1231(b).@ Estate of Shea v. Commissioner, 57 T.C. 15, 23 (1971), acq. 1973-2 C.B. 3. Therefore, property that was amortizable under § 1253 is properly treated as property of a character subject to the allowance for depreciation under § 167 and as section 1231(b) property rather than a capital asset.

The amortizable character of franchises transferred during the period between 1969 and the effective date of § 197 also determines their proper treatment for purposes of § 1245. For transfers after October 2, 1989, § 1245(a)(2)(C) provided that deductions allowable under § 1253(d)(2) or (d)(3) were treated as deductions for amortization for purposes of § 1245, and § 1245(a)(3) provided that property subject to the allowance for amortization in § 1253(d)(2) or (d)(3) was section 1245 property. The legislative history relating to the 1989 amendments of section 1245 and 1253 stated that no inference was intended as to the recapture requirements of prior law. As noted above, however, under the prior law the cost of a franchise was amortizable under § 1253(d)(2), including in cases in which the principal payments exceeded \$100,000. As is the case for purposes of § 1231, any franchise the cost of which was amortized under § 1245(d)(2) is properly treated for purposes of § 1245 as property of a character subject to the allowance for depreciation under § 167. Accordingly, such a franchise is section 1245 property.

Therefore, a distributor agreement acquired after 1969 and before the effective date of ' 197, for a fixed payment, including a fixed sum payable in a series of approximately equal payments, is amortizable under § 1253 and is treated as property of a character subject to the allowance for depreciation in ' 167. Because it is property of a character subject to the allowance for depreciation, it is not a capital asset, but gain from the sale or exchange of such property may be treated as capital gain under § 1231 and may be subject to recapture under ' 1245.

Franchises acquired before January 1, 1970

A distributor agreement entered into before January 1, 1970 (the effective date of ' 1253), is not amortizable, is not property of a character subject to the allowance for depreciation in ' 167, and is a capital asset under ' 1221. See Rev. Rul. 55-374, 1955-1 C.B. 370; Rev. Rul. 88-24, 1988-1 C.B. 306.

ANALYSIS

In the present case, A=s distributor agreement with X is for the marketing of goods, and A has made a substantial investment of capital in the distributorship as reflected in A=s inventory value. The cancellation did not occur by reason of the expiration of the agreement in accordance with its terms and the cancellation terminates all of A=s rights to sell product N. Therefore, ' 1241 applies to the cancellation of the agreement and X=s payment to A in cancellation of A=s distributor agreement is treated as an amount received in exchange for the agreement.

A=s distributor agreement gives A the right to sell N within a specific geographic area. Therefore, the agreement is a franchise under ' 1253(b)(1). A entered into the

distributor agreement after August 10, 1993, and holds it in connection with the conduct of a trade or business. Thus, the distributor agreement is an amortizable section 197 intangible and property of a character subject to the allowance for depreciation provided in § 167, and is not a capital asset. A's gain of \$30x from the payment for the cancellation of the distributor agreement qualifies under § 1231 as long-term capital gain, subject to recapture under § 1245 and recharacterization under § 1231(c).

If A had entered into the distributor agreement with X after 1969, but before the effective date of § 197, gain from the cancellation of the agreement would similarly qualify for § 1231 treatment. Because A paid X a fixed amount for the distributor agreement, the agreement would be amortizable under § 1253, and as a result would be property of a character that is subject to an allowance for depreciation under § 167. The \$30x gain from the cancellation would be treated as long-term capital gain under § 1231, subject to any applicable recapture under § 1245 and recharacterization under § 1231(c).

If A had entered into the distributor agreement with X before 1970, the agreement would be a capital asset and the \$30x gain from the cancellation would be capital gain.

HOLDING

1. The cancellation of a distributor agreement between a manufacturer and a distributor of the manufacturer's products is a sale or exchange of property if the distributor has made a substantial capital investment in the distributorship and the investment is reflected in physical assets.

2. Any resulting gain to the distributor is capital gain if the agreement is a capital asset. The gain is section 1231 gain and may be treated as capital if the agreement is property of a character subject to the allowance for depreciation under § 167. For this purpose, property is treated as being of such a character if it is amortizable under § 197 or § 1253. The section 1231 gain may be subject to recapture under ' 1245.

DRAFTING INFORMATION

The principal author of this revenue ruling is Maxine Woo-Garcia of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Ms. Woo-Garcia on (202) 622-7900 (not a toll-free call).