

Internal Revenue Service

Number: **201322020**
Release Date: 5/31/2013
Index Number: 1253.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

Refer Reply To:
CC:ITA:B02
PLR-137756-12
Date:
February 28, 2013

TY:

Legend

Taxpayer =

Supplier =
Company A =
Company B =
Products =
Product A =
Agreement =

Type X =

Amendment A =
Amendment B =
Period A =
Period B =

K =
M =
P =
Q =
R =
S =
T =
U =
V =
W =
X =

Y =

Z =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Type A Payment =

Type B Payment =

Type C Payment =

Type D Payment =

Type E Payment =

Type F Payment =

Type G Payment =

Type H Payment =

Type J Payment =

Dear

This responds to your request of August 29, 2012 for a private letter ruling concerning the proper treatment under § 1253 of the Internal Revenue Code of certain payments by Taxpayer.

FACTS:

Taxpayer is in the business of distributing Products and similar products from a wide variety of suppliers through a specific group of retailers under contract to Taxpayer from time to time ("Retailers"). Supplier supplies Product A, which is one of the "Products" that is distributed by Taxpayer.

Taxpayer and Supplier entered into the Agreement dated as of Date 1. Under the Agreement, Supplier authorizes Taxpayer to offer, sell, and distribute Product A through

Retailers for a term of Period B. The Agreement provides Taxpayer with a limited license to use Supplier's marks in connection with the sale of Product A.

As of Date 4, the terms of the Agreement provided as follows: The total purchase price of Product A paid by the customer consists of the Type H Payment and Type J Payment. The Type J Payment is remitted from Taxpayer to Supplier. Supplier pays Taxpayer the Type A Payment, which is equal to K percent of the Type J payment from each unit of Product A sold by Retailers. The Agreement sets forth a negotiated stated target number of units to be sold for each year (the "Stated Target"). The Stated Target increases each year over the term of the Agreement. Taxpayer is required to pay Supplier a Type B Payment for each year, which is a per unit payment of \$X for each unit of Product A sold by Retailers over the Stated Target for a given year. Taxpayer is also required to pay Supplier a Type C Payment for each year, which is a fixed annual amount corresponding to \$Y times the Stated Target for that year. If, in any given year, the total Type J Payments for Product A sold through Retailers does not exceed \$Z (the "Minimum Annual Sales Target"), Taxpayer is required to pay Supplier the Type D Payment, which is a fixed amount of \$W. Taxpayer is required to pay Supplier the Type E Payment, which is a per unit payment of \$V for each unit of Product A sold. The Type H Payment, reduced by the Type E Payment and the Type B Payment, is retained by Taxpayer and the Retailers (the "Taxpayer Retained Amount"). Amendment A made certain changes to the Agreement, including adding the Type A Payment, the Type C Payments and the Type D Payment, and extending the term of the Agreement to Date 6.

Either Taxpayer or Supplier may terminate the Agreement upon material breach, insolvency or bankruptcy of the other party, or, under certain circumstances, if a party ceases offering Products or Product A. If the Agreement is terminated before the end of its term, Taxpayer is obligated to pay only the Type C Payments that have accrued up to the date of termination. Additionally, if the Agreement is terminated, the obligation to pay the Type D Payment in the year of termination or any future year terminates.

Subsequent to Date 4, Taxpayer and Supplier entered into Amendment B, which makes certain changes to the Agreement, including (a) the Type C Payments for the period from Date 3 through Date 7 are reduced by \$U per year; (b) beginning Date 7, the Type C Payments are eliminated; (c) Beginning Date 7, the Type B Payment is reduced from \$X per unit sold of Product A to \$T per unit sold, and applies to every unit sold (i.e. the Type B Payment will no longer apply only to sales in excess of the Stated Target); (d) beginning Date 7, the Type E Payment is eliminated; (e) Taxpayer shall retain the Type F Payment, which is an additional \$R to \$S per unit of Product A sold; (f) beginning Date 5, Supplier will pay to Taxpayer the Type G Payment, which is based on the total Type J Payments for Product A sold through Retailers for a given year (\$R per unit for total Type J Payments between \$P and \$Q, and \$M per unit for total Type J Payments above \$Q); (g) beginning Date 7, the Type A Payment is eliminated; and (h) the term of the Agreement is extended to Date 8. In addition, Taxpayer and Supplier

are considering an amendment to make certain additional changes to the Agreement, including clarifying the specific amount of the Type F Payment between \$R and \$S for particular Product A sales and that the Type D Payment will not apply to contract years beginning after Date 6.

All of the payments by Taxpayer to Supplier that are described in this FACTS section are made no less frequently than annually.

The Taxpayer makes the following representations:

1. The Agreement is not a sale or license, except to the extent that Supplier grants to Taxpayer and the Retailers a limited license to use Supplier's marks in connection with the sale of Product A.
2. Under the Agreement, Supplier is hiring Taxpayer to promote, sell, and distribute Product A.
3. The Type H Payment is determined by Taxpayer based on a recommendation by Supplier.
4. The Type C Payments, the Type D Payments, Type B Payments, and the Type E Payments, and the Type J Payments are the only amounts that are or will be paid or remitted by Taxpayer to Supplier for the sale of Product A.
5. The division of revenue between Taxpayer and the Retailers from the sale of Product A is the result of an arm's length negotiation and is comparable to the division of revenue between Taxpayer and Retailers of products similar to Product A.
6. The Type C Payments and Type D Payments were intended by the parties to the Agreement to encourage Taxpayer's continued promotion of Product A.
7. The Type B Payments were intended by the parties to the Agreement to provide Supplier with a share of the revenue from the sale of each unit of Product A over the Stated Target.
8. The Type A Payments, together with the Taxpayer Retained Amount, were intended by the parties to the Agreement to compensate Taxpayer for providing certain services relating to Product A under the Agreement in a manner that encourages Taxpayer's continued promotion of Product A.
9. The Type E Payments were intended by the parties to the Agreement as an offset, to the Taxpayer Retained Amount and to compensate Supplier for certain expenses relating to Product A.
10. At the time Taxpayer agreed to the Type C Payments and Type D Payments, Taxpayer expected both the Stated Target and Minimum Annual Sales Target to be exceeded.
11. Taxpayer uses Supplier's marks solely on the packaging of Product A, in the area where Product A is displayed for sale and in marketing materials related to Product A.
12. Taxpayer sells products that compete with Product A in the same places and in the same manner as Product A; provided, however, that a Retailer may display Product A on a stand-alone basis for a limited period of time as part of a special marketing program.

13. Taxpayer is the exclusive distributor of Product A only with respect to the Retailers with certain exceptions, including that Supplier was permitted to sell Product A through only Taxpayer, Company A, or Company B with respect to a Type X version of Product A during a period of Period A following Date 2.

14. Except to the extent that Taxpayer agrees to distribute Product A in accordance with the Agreement, Supplier does not participate in, or have control over, Taxpayer's business.

LAW AND ANALYSIS:

Section 1253(a) of the Code provides as a general rule that a transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

Section 1253(b)(1) provides that the term "franchise" includes 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.

Section 1253(b)(2) provides that the term "significant power, right, or continuing interest" includes, but is not limited to, the following rights with respect to the interest transferred:

- (A) A right to disapprove any assignment of such interest, or any part thereof.
- (B) A right to terminate at will.
- (C) A right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services.
- (D) A right to require that the transferee sell or advertise only products or services of the transferor.
- (E) A right to require that the transferee purchase substantially all of his supplies and equipment from the transferor.
- (F) A right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

Section 1253(c) of the Code provides that amounts received or accrued on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred shall be treated as amounts received or accrued from the sale or other disposition of property which is not a capital asset.

Section 1253(d)(1)(A) provides that, in general, any amount described in § 1253(d)(1)(B) which is paid during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name shall be allowed as a deduction under § 162(a) of the Code (relating to trade or business expenses).

Section 1253(d)(1)(B) provides that an amount is described in § 1253(d)(1)(B) if it

- (i) is contingent on the productivity, use, or disposition of the franchise, trademark, or trade name,
- and (ii) is paid as part or a series of payments
 - (I) which are payable not less frequently than annually throughout the entire term of the transfer agreement, and
 - (II) which are substantially equal in amount (or payable under a fixed formula).

Section 1253(d)(2) provides that any amount paid or incurred on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name to which § 1253(d)(1) does not apply shall be treated as an amount chargeable to capital account.

The Tax Reform Act of 1969, P.L. 91-172, added § 1253 to the Code. According to the Senate Committee Report, S. Rep. No. 91-552, "The committee amendments also provide that the term 'franchise' includes 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. This would include distributorships or other similar exclusive-type contract arrangements to operate or conduct a trade or business within a specified area, such as a geographical area to which the business activity of the transferee is limited by the agreement." The Report also states that

If the transfer agreement includes significant conditions or restrictions which are subject to the transferor's approval on a continuing basis, this power to exercise continuing, active, operational control over the transferee's business activities is to be considered as a retention by the transferor of a significant power, right, or continuing interest. Moreover, if the transferor's conduct constitutes participation in the commercial or economic activities of the transferee's business, then this also is to be regarded as a retention of a significant power, right, or continuing interest.

Based on the facts presented, we hold that § 1253 does not require the taxpayer to capitalize the payments by Taxpayer to Supplier that are specifically mentioned above in the FACTS section. If the taxpayer makes the additional amendments to the Agreement that are specifically discussed above in the FACTS section, this holding will continue to be valid.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

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

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Thomas D. Moffitt
Branch Chief, Branch 2
(Income Tax & Accounting)

cc: