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IRS Makes Determination on Franchise Termination Payment Agreements

In Private Letter Ruling 201317003 released in April, the IRS determined whether a termination payment made to a franchisee was (1) an amount paid to acquire or an amount paid to create an intangible and (2) if it is properly amortizable over the duration of the franchisee's original useful life under section §197.

The Taxpayer was a U.S. corporation and a party to two franchise agreements. Termination of the agreements was subject to certain circumstances and occurrences. After a period of time, the Taxpayer unilaterally decided that termination was in its best interest. Notwithstanding the initial unilateral decision, there was a mutual agreement to terminate by both the Taxpayer and the franchisee conditioned on a termination payment by the Taxpayer.

The IRS first took on the issue regarding the categorization of the termination payment under Regs. 1.263. Section 263 generally provides that a deduction cannot be made for an amount paid that would be considered a capital expenditure. "Generally under these rules. A taxpayer must capitalize an amount paid to (1) acquire an intangible; (2) create an intangible; (3) create or enhance a separate and distinct intangible asset; (4) create or enhance a future benefit identified in the Federal Register or the Internal Revenue Bulletin as an intangible for which capitalization is required; or (5) facilitate the acquisition or creation of an intangible." (Tax Management Memorandum, Tax management Inc., subsidiary of the Bureau of National Affairs, inc. 201.) Furthermore, there are rules that focus specifically on the application of §263 to amounts paid to acquire or create intangibles. Regs. 1.263(a)-4(a)(1)(viii) requires the capitalization of amounts paid to another party to acquire a franchise and Regs. 1.263(a)-4(d)(1) requires the capitalization of amounts paid to create an intangible, which includes amounts paid to another party to terminate certain agreements.

Section 263 requires capitalization for acquired and created intangibles; however, there are different rules that apply to the different types. The IRS reasoned that the termination payment

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here resulted in the creation of an intangible because the termination voided the prior agreements that gave the franchisee the exclusive right to distribute the Taxpayers products in a certain territory. Therefore, the payment is governed by Regs. 1.263(a)-4(d)(7)(i)(B).

The IRS then took on the question of whether amortization is proper under §167 or §197. The Taxpayer requested that the payment be amortized using §197 over the remaining useful life of the intangible asset using the remaining portion of the 15-year statutory life. The IRS requested a list of intangible assets or interest therein, that the Taxpayer acquired upon entering into the termination agreement to determine whether amortization was proper under §197 for this set of facts. Generally §197 does not apply to intangibles that are created unless they are created in connection with the acquisition of a trade or business. However, the Taxpayer did not supply the list and the IRS was unable to correctly determine whether the payment was an amortizable §197 intangible. This forced the hands of the IRS and required the depreciation to be determined by §167.

Regs 1.167(a)-3(b) provides a 15-year useful life safe harbor for intangible assets with indeterminable useful lives, starting on the first day of the month that the intangible is placed into service. The IRS allowed the Taxpayer to recover under §167 only if the Taxpayer knew that the intangible assets were to be of use in the business or in the production of income for a limited period of time, estimated with reasonable accuracy. If the Taxpayer is unable to make that determination then they are free to use the 15-year safe harbor however, the Taxpayer may not amortize the asset over the remaining life of either franchise.

Thanks to Katherine Danial, Chicago Summer Law Clerk, for her assistance with the writing of this blog post.

Contact: Ryan Holmes
312.580.1238
rholmes@ralaw.com

Labels: 15-year safe harbor, franchise agreements, IRS, termination payments

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